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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in France

Report of the Secretary-General

SUMMARY

The Government of France began a series of actions in the 1980s which led to the privatization of some of its major State enterprises. The exercise was undertaken to improve the financial results of nationalized industries, which were a continuing burden on the economy, and to expand the country's capital markets. Privatization was achieved primarily through stock exchange flotations and sales of shares to employees. These methods required a large public relations effort to explain to citizens the motives of the Government in taking these steps. A great deal of planning and control was also required for the process to be executed efficiently. The most significant problem that arose was the selection of the most appropriate assumptions and bases to be used in the valuation of the enterprises. Bookkeeping and accounting issues

* E/C.10/AC.3/1992/1.

were minimal in most cases because commercial financial accounting systems are used by enterprises in France. Significant problems can arise, however, when components of enterprises are selected for transfer of ownership. Accounts and transactions are frequently interrelated among the various segments of a large enterprise, which makes them unrepresentative of the past operations or expectations for the future when used for evaluation of a component of the enterprise.

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I. OBJECTIVES OF PRIVATIZATION

1. The privatization programme, which got under way in France in 1986, was one of a series of important measures taken in the mid-1980s to strengthen the economy and change the structure and dimensions of the financial markets, bringing about, in effect, a financial revolution. In France, a country with a rigid legal structure and multiple economic controls, the financial framework had traditionally been dominated by regulation. This situation was aggravated by the nationalization of a number of industrial and financial groups which took place in 1981. Debt financing, through banking channels, was the usual method of raising capital, so capital market financing was underdeveloped and the stock market was weak in comparison with other modern industrial countries. In 1985, for example, the capitalization of the financial market was some 600 billion francs and the volume of its transactions valued at about 166 billion francs (Durupty, 1988, p. 34). Both the size and the volume of the French capital market were only about one quarter that of London's market. The volume was 17 times greater in Tokyo and 53 times greater in New York than the volume on the French stock market. The other European countries, in anticipation of the single European Community in 1992, had been engaging in large-scale deregulation of financial and banking services, with most attention being drawn to London's "Big Bang". France could not afford to be left behind.

2. Banking problems, largely associated with the 1982 Latin America crisis, international competition for capital and an expanding commercial interest in raising funds with a variety of maturities, stimulated the creation of new financial instruments and capital markets in France (Durupty, 1988, p. 22). The Banking Act of 1984, and related legislation, brought uniformity of regulation for all financial institutions. An extensive reform of the French Stock Exchange was put into effect in 1986, increasing competition by freeing fees and permitting the purchase of shareholdings by French and foreign financial institutions in accordance with an exact schedule. Also in 1986, a financial futures market (MATIF) was opened in Paris and, a year later, a negotiable option market (MONEF) was started. New instruments to meet the financing needs of banks, corporations and individuals came into use. These included the issuance of short-term negotiable certificates, denominated in either French or foreign currencies, by banks, commercial paper (billets de Trésorerie) issued by corporations, and notes (bons des institutions) issued by financial institutions.

3. The privatization programme, created by legislation passed on 2 July and 6 August 1986, 1/ was rooted in the denationalization policies of the new Government, which was voted into office at the beginning of the year. The principal privatization objectives, based on the denationalization principles, were:

(a) To improve the economic and financial performance of enterprises by guaranteeing management autonomy;

(b) To relieve the State Treasury from the weight of chronic deficits accumulated by certain public enterprises;

(c) To develop the financial markets and expand popular shareholding (actionnariat populaire) (Durupty, 1988, p. 33).

4. Despite affirmations of management autonomy in State-owned enterprises, government intervention was frequent. For example, the presidents of all the large banks were replaced in 1982 and one bank, engaged in international competition, had a succession of five presidents in five years appointed by the Government. Other public enterprises claimed that they were required to adopt various policies working against their own best interests in the period 1981-1986. These included rejecting acquisition investments, obligatory transfers of funds in restructuring processes that penalized prosperous enterprises, and being required to apply for outside funds rather than use internally generated resources. Removing government ownership was seen as the major way to make management responsive to the imperatives of the market and demands of the shareholders, rather than to the requirements of the oversight body. Privatization would also facilitate the adaptability needed under conditions of changing technologies and international competition.

5. The second privatization objective was aimed at providing budget relief in two ways: removing the necessity of subsidizing deficits and also benefiting from receipts from the sale of State assets. While it is difficult to calculate France's public sector borrowing requirement because, among other things, the social security system and various State agencies borrow on their own account, the public sector borrowing requirement probably approximates between 2.1 and 2.5 per cent of the gross national product which would suggest deficits of 129 billion francs in 1987 and 115 billion francs in 1988 (Durupty, 1988, p. 110). However, the effect of privatization proceeds, originally estimated at 30 billion francs for 1987, could have been assumed to be quite modest as a per cent of public sector borrowings. (As it happened, actual receipts were considerably higher: 70.8 billion francs for the two years 1986 and 1987.)

6. State enterprise deficits did not play a sizeable part in total State budget deficits either. The accumulated financial results for the 17 public industrial groups for the six years 1980-1985 showed that nine incurred deficits of 98 billion francs and eight had profits amounting to 39.74 billion francs. One group, Elf-Aquitaine, was the leading profit maker, while three groups were the loss leaders, as shown below (Durupty, 1988, p. 19):

Profitable companies	Amount (Billions of francs)	Per cent	Loss-incurring companies	Amount (Billions of francs)	Per cent
Elf-Aquitaine	28.50	72	Sacilor	27.30	28
Others (7)	11.24	28	Renault	26.90	27
Total	39.74	100	Usinor	26.30	27
			Others (6)	17.50	18
			Total	98.00	100

7. In keeping with the conventional wisdom that those State enterprises with the best financial condition should be the first to be privatized, Elf-Aquitaine was the first State enterprise to be put on sale (on 26 September 1986). This means, all other things being equal, that the State budget can expect no significant relief from State-owned enterprises' operating deficits until some passage of time when tax receipts start to come in from privatized enterprises and when some restructuring of the loss-incurring enterprises, to improve their financial operating potential, could be carried out.

8. One feature of the French privatization programme that has attracted favourable attention is its provision that privatization proceeds go into a separate government account. The proceeds can then be used, at the Government's discretion, for reducing the national debt and/or for subsidies to State-owned enterprises being restructured for eventual privatization, such as Renault, or for special infrastructure projects. The use of net receipts in 1987, and estimated for 1988, expressed in billions of French francs, was as follows (Les notes bleues, 1987, p. 4):

	1987		1988	
	Amount (Billions of francs)	Per cent	Amount (Billions of francs)	Per cent
National debt reduction	33.9	66	35	70
Capital assistance	17.5	34	15	30
Net receipts	51.4	100	50	100

9. While privatization programmes have been attacked from various sources and for various reasons, the fact that, generally speaking, Governments have been using privatization proceeds to cover government spending has drawn more emotional fire than most other issues. Because newly privatized companies are often in need of start-up capital, the French approach has been hailed by Letwin (1988, pp. 69-70), among others, as:

> "... [an] extremely ingenious decision ... This move, made right at the start of the privatization programme, has dealt effectively with all the attacks that would otherwise undoubtedly have arisen from commentators claiming that the French Government was selling the family silver ... Moreover, this policy has a serious economic rationale. By ensuring that the proceeds are devoted to the capital account, the French Government has prevented itself from using privatization as a means of masking increased public expenditure; the policy is therefore a self-constraining measure, of which any treasury or finance ministry would be proud."

10. The final privatization objective was to develop the French financial markets by expanding both domestic and foreign investment. This is linked to stimulating the interest of the general public in buying shares, in particular shares of the company by which they are employed. Under the previous Government, democratization of the public sector involved having the workforce represented as members of an enterprise's administrative council. The new Government sought to change the employee's perspective from potential adversary to become allied with the owners as fellow shareholders. The success of the United Kingdom with this policy, which involved special prices and payment terms for employees, was echoed in France. Between November 1986 and February 1988, 12 groups, accounting for 29 of the 65 enterprises selected for privatization, were transferred over to private ownership, in addition to the country's leading television station, TV1, and a bank, Caisse nationale de crédit agricole. Both employees and the public at large responded enthusiastically to the public share offerings (Bourdon and others, 1989, pp. 138-139). As shown in the table, at least 50 per cent of the employees in each of the 12 groups analysed purchased shares, while for three of the groups the participation was 80 per cent or better. The general public responded so enthusiastically that the available number of shares had to be reduced with each privatization operation. Public shares offerings after the stock market crash of October 1987, notably with respect to Suez, encountered significant difficulty. However, as the table shows, by November 1988 share prices had recovered to the point where most shareholders, except those of Sogénal and BTP, were experiencing holding gains.

11. The French privatization programme had drawn attention to and interest in the Paris Bourse and it probably had some influence in attracting investments. However, the programme was just one of several measures taken, plus there were two other factors that make evaluation of this objective difficult. One was the world-wide stock market declines of late 1987, the other was the fact that the privatization programme in general came to a halt when, in 1988, there was once again a change of Government.

Position of State enterprises privatized by February 1988

Enterprises and dates sold	Subscribers (in thousands)	Percentage of employees subscribing	Public offer price (POP) (in francs)	Prices (in francs) at 30 Apr. 1988 a/	Prices (in francs) at 15 Nov. 1988	Price at Nov. 1988 as percent of POP
Saint-Gobain 24 Nov. 1986	1 540	50.0	310	407.00	544.00	175.48
Paribas 19 Jan. 1987	3 810	50.0	405	350.00	454.00	112.10
Sogénal 9 Mar. 1987	850	78.5	125	92.50	110.00	0.88
BTP 6 Apr. 1987	1 030	88.0	130	129.00	120.00	0.92
BIMP 21 Apr. 1987	520	81.0	140	198.50	180.00	128.57
CCF 27 Apr. 1987	1 650	80.0	107	111.80	170.00	158.88
Havas 25 May 1987	730	55.0	500	540.00	715.00	143.00
CGE 11 May 1987	2 240	50.0	290	243.00	392.50	135.34
Sociéte générale 15 June 1987	2 300	69.0	407	280.10	524.00	128.75
TFI Autumn 1987	416	50.0	165	190.00	311.00	188.48
Suez Autumn 1987	1 600	60.0	317	226.80	317.50	100.16
Matra Winter 87/88	302	60.0	110	163.90	214.00	194.55

Source: French Treasury Report (December 1988), p. 19. Quoted by Reuters, 7 December 1988.

a/ 30 April 1988 was before the presidential election.

/...

II. PRIVATIZATION METHODS USED IN FRANCE

12. The financing methods specified by the privatization law follow two main types of processes. The first, which is used the most frequently, offers three possible ways of transferring ownership through the stock market: (a) through a public offer for sale, (b) through a public offer of exchange or (c) under the form of an increase in capital. The second way takes place outside the market through sale by private contract on an auction basis or through sale to the employees. During the period between November 1986 and July 1987, the beginning of the privatization programme, there were 10 groups or enterprises privatized, including the sale by private contract of the television station TV1, the net proceeds of which amounted to 45.6 billion francs. The distribution by source of financing is as follows (Longueville, 1987, p. 17):

	Amount (Billions of francs)	Per cent
Public offer for sale	24.0	52.6
Employees	4.3	9.4
Total (of which households account for FF 28 billion)	28.3	62.0
Outside the market	10.0	22.0
Total domestic	38.3	84.0
Overseas	7.3	16.0
Total net proceeds	45.6	100.0

A. Public offer for sale

13. Sale at a fixed price has several advantages of simplicity of procedure, transparency and flexibility. The Minister for the Economy, Finance and Privatization sets the price per share after receiving a recommendation from the Privatization Commission and the purchase price is known to the buyers, although not the way in which the Minister arrived at the amount. All the operations are centralized through a neutral body: the Stockbrokers' Chamber (Chambre syndicale des agents de change) which guarantees openness and fairness in the procedure. Lastly, the number of shares offered versus the number of shares subscribed for is evaluated and some equivalence established, so the process is somewhat flexible. Also, the law of 6 August 1986 provides that, under certain conditions, natural persons of French nationality, or French residents, may have priority with respect to share subscriptions. Thus, orders for shares can be sorted into categories based on available priorities.

14. The techniques used in selling shares by public offer during the period 1986-1988 were as follows. The State notified the general public of the terms of the offer by way of a notice published in the official quotations of the

Company of Stockbrokers (Compagnie des agents de change). This was then widely published by the Press and financial intermediaries. The usual offer period ran for two weeks and offers were submitted to the financial houses, which forwarded them to the Chamber. This centralization of orders made it possible to determine exactly how many shares were being subscribed for.

15. The State took several steps to enhance the possible success of the sales. First, it bore the costs connected with acquiring shares, in effect giving up the value-added and stamp revenue receipts. For the Saint-Gobain sale, the State saved about 173 million francs by negotiating with the banks to lower brokerage costs and the usual 2 per cent commission for periods in which they hold shares in trust (Durupty, 1988, p. 70). Another measure was a publicity campaign with two phases: the first, informing the public about the activities of the enterprise to be privatized, and the final phase, conditioning public opinion in favour of subscribing. The media were widely used at the beginning of the privatization programme. However, once it became evident that the programme was going well, the publicity budgets were cut back. To encourage employee participation in the share offerings, the enterprises themselves engaged in internal publicity activities using various media such as video films and in-house information pamphlets.

16. After subscriptions closed, the Chamber proceeded with the publication of the results of the offer and the ground rules for filling the orders, including reductions that would be made in orders as a result of oversubscription. As further public offerings led to further oversubscription, the State modified the conditions for attributing shares to subscribers, such as drawings by lot, or decreasing the nominal value of shares in order to increase the number of available shares proportionately. The shares were then registered.

B. Public offer of exchange

17. This technique consists of allowing subscribers to exchange investment certificates (certificats d'investissements) and participating shares (titres participatifs) for shares in the privatizing company. These instruments, which do not convey the right to vote and which have priority rights to dividends, were issued by nationalized industries after they had been permitted by the Delors law of 1983 (Law No. 83-1 of 3 January 1983) to draw on public savings for funding needs.

C. Increase in capital

18. This technique, which was used for Sogénal, CGE and Rhône-Poulenc, allows an enterprise to increase its capital, when the State is also a shareholder, without, however, permitting the State to exercise its preferential right to subscribe for the additional shares. In certain cases, such as that of Sogénal, the State may subscribe for additional shares in order to resell them by public offer and thereby increase the privatized company's funds.

D. Sale by private contract through auction

19. This approach was specified in Law No. 86-793 of 2 July 1986, which allowed transfer of ownership, and Law 86-912 of 6 August 1986 and the application methods defined in the decree of 24 October 1986 (Decree No. 86-1140). Basically, it consists of the sale of enterprise shares at a fixed price as well as a sum that may vary depending on enterprise operations. There can be either a total or a partial transfer of shares, but in the greatest number of cases a partial transfer has been employed. The procedure is the same in both instances but the objectives for each are different. In the case of a partial transfer, the State is interested in assuring the stability of that part of the shareholder body that will be controlling the enterprise. This stable group, which became known as the "hard core" (noyeau dur), is nominated by the State, which led to considerable criticism of the Government for perceived favouritism. A partial transfer is then linked up with a public offer for sale in a subsequent phase.

20. In the case of a total transfer, on the other hand, the choice of the purchaser will have a strong bearing on the potential for the enterprise. Among the State's considerations are the professional and financial abilities of the would-be purchaser(s) versus the industrial strategy of the group to be privatized, as well as the market characteristics in which it is positioned and its market potential.

21. The procedure followed during the privatization programme was the same for both partial and full transfers. The first phase was that of audit and valuation and submission of recommendations to the Privatization Commission. The Commission then gave its opinion to the Minister for the Economy, Finance and Privatization, who, in the case of a partial transfer, determined the percentage of the capital to be reserved for the auction sale. This percentage constituted the maximum that could be modified at the time of examining the offers. This was generally set at 20 to 30 per cent, but was set at 50 per cent in the case of the auction sale of TV1 (Durupty, 1988, p. 75).

22. The bidders obtained details of the financial condition of the operation from the specifications (Cahier des charges) obtainable from the Treasury. These generally provided for the payment of a premium, calculated as a percentage of the price of the shares to be offered by public sale, and was a variable amount - usually about 5 per cent. The second part of the document dealt with the offers to purchase. The subscribers set out their offers and responded to a questionnaire in which they described their perspectives on the future prospects for the company. The third part had to do with the choice of candidate(s) and established a pre-selection procedure, allowing candidates a certain time period to confirm or retract their offer after being advised of the price of shares for public sale. In addition, there was information about the payment terms, the fact that transferability of the shares would be frozen for two years, the applicable contract law, and the competent jurisdiction in case of litigation.

E. Purchase by employees

23. French interest in sales to employees was sparked by the success of leveraged management buy-outs in the United States and the United Kingdom and a three-stage procedure was developed. In the first stage, a holding company is created, with at least 50 per cent of the voting rights reserved for those employees interested in buying shares. The remaining capital is usually taken up by banks or other financing groups. During the second phase, the holding company proceeds with the resale of the enterprise to the employees, holding back at least 50 per cent of the voting rights. This is usually financed by loans subscribed for by the holding company and guaranteed by banks. In the last phase, the holding company receives dividends from the enterprise which the holding company uses to pay off the loans.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

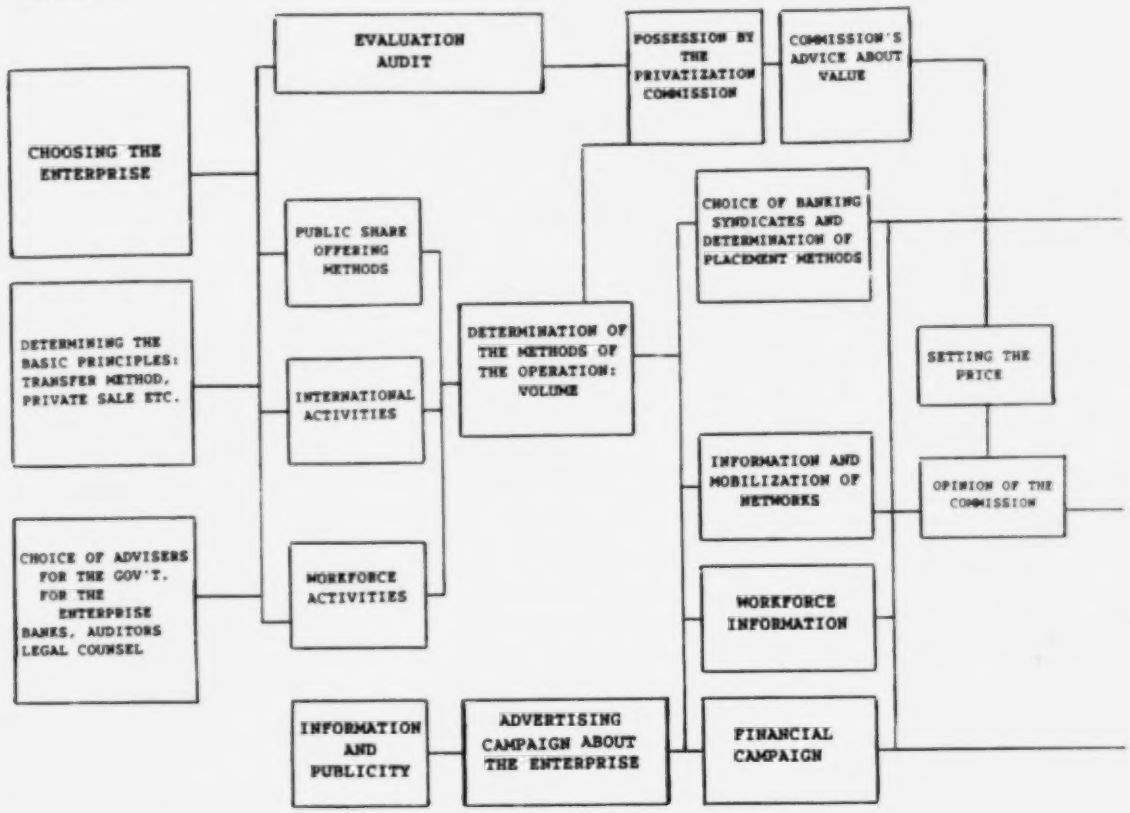
24. One of the keys to implementing a privatization operation successfully is careful planning and control of the process, particularly when so many participants are engaged. The fact that 10 privatizations were successfully concluded during the first year of France's programme attests to the fact that the Ministry of the Economy, Finance and Privatization had expedited the process efficiently.

25. The Ministry's implementation strategies are described in Les notes bleues (1987), which contains a programme evaluation and review technique (PERT)-chart type calendar of events showing the principal activities carried out by the seven groups involved and the related due (deadline) dates, with the entire process timed to take four and one half months for each privatization. A simplified version of the calendar is presented in the figure, which contains flow charts of the main activities carried out in the three phases of a privatization project: (a) making the major preparatory decisions and arrangements; (b) carrying out studies and making necessary and technical arrangements; and (c) carrying out the transfer of ownership.

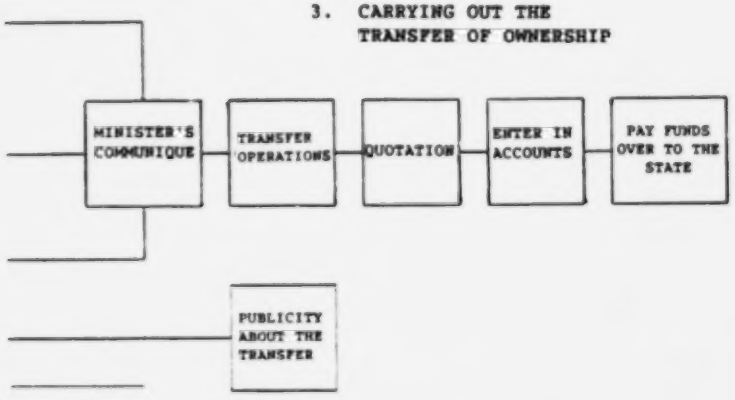
Implementing a privatization operation

1. MAJOR PREPARATORY DECISIONS

2. STUDIES AND TECHNICAL AND LEGAL PREPARATIONS


EVALUATION AUDIT
POSSESSION BY THE PRIVATIZATION COMMISSION
COMMISSION'S ADVICE ABOUT VALUE
CHOOSING THE ENTERPRISE
PUBLIC SHARE OFFERING METHODS
CHOICE OF BANKING SYNDICATES AND DETERMINATION OF PLACEMENT METHODS
DETERMINATION OF THE METHODS OF THE OPERATION: VOLUME
DETERMINING THE BASIC PRINCIPLES: TRANSFER METHOD, PRIVATE SALE ETC.
INTERNATIONAL ACTIVITIES
SETTING THE PRICE
INFORMATION AND MOBILIZATION OF NETWORKS
OPINION OF THE COMMISSION
CHOICE OF ADVISERS FOR THE GOV'T. FOR THE ENTERPRISE BANKS, AUDITORS LEGAL COUNSEL
WORKFORCE ACTIVITIES
WORKFORCE INFORMATION
INFORMATION AND PUBLICITY
ADVERTISING CAMPAIGN ABOUT THE ENTERPRISE
FINANCIAL CAMPAIGN

3. CARRYING OUT THE TRANSFER OF OWNERSHIP



Source: Michael Durupty, Les privatisations en France (Paris, La documentation française, 1988), pp. 62-63.

A. Preparatory phase

26. The first phase consists of selecting the candidate for privatization and the appropriate financing method. This was carried out at the ministerial level in advance of the operations calendar. The calendar starts when the Minister for the Economy, Finance and Privatization makes a public announcement of the planned privatization. In France, the Minister personalized this process by television and radio appearances as well as press conferences in order to broaden public appeal. At the same time, offers to bid are issued for banking and auditing counsellors, with both French and foreign firms competing for appointments. The responding bidders submit their proposals on official forms to the Director of the Treasury. The proposals are then forwarded to a selection committee, which makes its recommendations to the Minister.

27. The bankers and auditors have quite distinct and separate duties, although they work in close cooperation with each other. The auditors examine the latest consolidated balance sheet and statement of results, as well as the accounting principles used in their construction, and also evaluate the increases or decreases in net assets arising from any revaluation. In carrying out this work, they should, to the extent possible, have close contact with the enterprise's other auditors, if any, and use the work already performed by the statutory auditors (commissaires aux comptes) and inspectors (commissaires-controleurs) with whom they share the same investigative rights and confidentiality obligations. To stress auditor independence, auditing firms were not considered if they had an auditing engagement with the privatizing company during the prior three years in which the audit fees exceeded 15 per cent of the privatizing company's total external audit budget, whether in France or elsewhere. Fees for privatization audits can be substantial and there was keen competition in France, particularly among the international firms. This caused concern among the local French firms and caused a modification in the selection process, which then provided for two auditing firms to be selected for each engagement by adding a French firm in the case that an international firm was also chosen (SIC, 1988 b, pp. 17-19).

28. The investment bankers' task is to prepare an initial evaluation of the privatizing company using the broad principles laid down in article 3 of the privatization law. The principles include the use of objective accounting methods currently practised for this type of operation; appropriate consideration of the market value of shares, which the privatizing company, or a similar company if one exists, may have already issued, in comparison with the value of the net assets; the company's profitability; the existence, if any, of subsidiary companies; and future potential and prospects.

29. A major problem is that the valuation of an enterprise can vary depending on the type of financial analysis used in the calculation. In 1987, for example, the French Press published seven different possible evaluations of Paribas, as follows (Durupty, 1988, p. 66):

Evaluation bases	Amount (Billions of francs)
Rate for redemption certificates during the last trimester of 1986	21.5
Dividend paid	19.4
Revaluated net assets	19.6
Price/earnings ratio	17.9
Direct participation	17.7
Price/net assets ratio	17.6
Valuation by stockbrokers at 430 francs per share	20.5

30. These variations complicated the task of the Privatization Commission, which later submitted its recommendations for sales value to the Minister.

B. Intermediate operations

31. The second phase of the privatization operation starts in the third week of the plan, after the selection of the auditors and investment bankers, with the convening of the Privatization Commission. In the meantime, the company to be privatized selects the publicity firm to start drawing up the campaign project. During the next month, the auditors and investment bankers complete their assignments. The auditor's report goes to five different users: the Minister for the Economy, Finance and Privatization, the audit client, the banks, the Privatization Commission and the Exchange Commission. The investment bankers' report goes to the Minister and the Privatization Commission - the latter having already been furnished with an earlier interim report.

32. The Privatization Commission was created as a government strategy to emphasize the objectivity of the evaluation process and to set up a buffer between the Minister and the ultimate purchasers for negotiation purposes. The French Commission was composed of seven members, nominated by decree for five-year terms, and selected on the basis of their expertise in economic, financial or legal affairs. The Commission's president was a former Minister, member of the Council of State, member of the Constitutional Council and president of the Securities Commission (Baudeu, 1987, p. 57). Of the remaining six members, two had been presidents of state-owned enterprises about to be privatized and therefore knew their operations very well; two others had held high positions in finance and banking; one was president of the commission for auditing the accounts of public enterprises; and one was a professor of law. All were constrained to professional secrecy and were not permitted, under the penal code, to have any direct or indirect managerial function with respect to the privatizing companies. This prohibition had a five-year retroactive application.

33. After consulting behind closed doors, the Commission recommended a floor price for the sale of shares, or assets, as the case may be, to the Minister for the Economy, Finance and Privatization. In the case of Paribas, described earlier, where valuations ranged between 17.6 and 21.5 billion francs, the

Commission's floor recommendation was set even lower at 17.5 billion francs. The Minister did not disclose how he arrived at his decision concerning the final sales price. However, it was soon evident that pricing low to enhance potential sales was a major strategy since the Commission's floor price recommendations were published to provide an extra measure of public confidence in the fairness of the offer. This resulted in the so-called "premium effect" as the first rates quoted after the fixed offer price was announced were higher, as shown below, for the first eight groups privatized (Longueville, 1987, p. 12 and Durupty, 1988, p. 67):

	Public offer price (FF)	First quoted price (FF)	Premium	
			Amount	Per cent of
Elf-Aquitaine	305	320	15	4.92
Saint-Gobain	310	369	59	19.03
Paribas	405	480	75	18.52
Sogénal	125	225	100	80.00
BTP	130	176	46	35.38
BIMP	140	170	30	21.43
CCF	107	125	18	16.82
CGE	290	323	33	11.38

34. In the short run, share sales will be stimulated by the expectation of rapid premiums, but, with the exception of Sogénal and possibly BTP, the premiums were somewhat modest. As shown earlier, in the table in section I, the public offer price for Sogénal was a more conservative predictor of longer-run values than the first quotation, since Sogénal share prices had plunged to 110 by November 1988. However, the longer-run share values support initial criticisms of underpricing.

35. By the middle of the third month of the plan, the Ministry fixes share prices, or selects the hard core of shareholders, as the case may be, and announces the details of the public offering. The Securities Commission will have completed its examination of the documents filed and made the preparation for the stock listings; the Privatization Commission will have completed its work; and the investment bankers will be sending out information, usually by telex, to their own agencies and other bankers world wide. In the meantime, the publicity campaigns will be proceeding within the enterprises and through the national and international media.

36. In determining the availability of shares, the Government of France set certain limits of control for preventing possible shareholder monopolies, protecting the national interest and allowing preferential treatment for employees, French nationals and French residents in order to achieve the objective of building up public shareholding interest (Baudeu, 1987, p. 5). To try to prevent shareholder monopolies, no physical or legal person could

acquire more than 5 per cent of the shares offered, if the Minister so determined. However, this limitation could only be put into effect in the case of the initial sale and no provisions were made for indirect acquisitions. Consequently, those interested in larger investments were not constrained in the longer run. Sales of shares to foreign physical or legal persons, or those under foreign control, could not exceed 20 per cent of the company's capital. This threshold had been raised from 15 per cent in anticipation of possible problems being raised by the Court of Justice of the European Community (EC) over access to shares by EC members. The State also reserved for itself the right to transform any ordinary share it held or acquired into a "specific" share, on the model of the United Kingdom's "golden" share, giving the Government certain powers to protect the national interest. This mainly consisted of allowing the Government to authorize investments in excess of 10 per cent by one person or by a group of persons acting collectively, but this privilege was rarely invoked, as in the privatization of Bull, Elf, Havas and Matra, for example (Longueville, 1987, p. 10).

37. Employees benefited from a special allocation, a special price, and the possibility of deferred payments. The work force was entitled to buy up to 10 per cent of the shares of their company, limited, however, in amount to five times the annual ceiling of social security contributions. Price rebates, up to a maximum of 20 per cent, could be granted, and deferred payments for a period not to exceed three years could also be authorized. If the price rebate exceeded 5 per cent, however, employees were obliged to maintain ownership for a specified period, which was generally two years. Also, shares were not transferable before they were fully paid for. As an additional incentive, the State could grant one free share for every 10 shares purchased, but a time-limit of one year was imposed for holding purposes. Non-employee French citizens or residents were given priority to acquire up to 10 shares each, and the Government could also grant free share distributions and allow deferred payment arrangements.

38. As an additional incentive, the privatization law of 6 August 1986 allowed partial payment in securities rather than cash. Up to 50 per cent of the total of each acquisition could be paid for using bonds issued by the State. Other securities that could be used for such purposes were the investment certificates or participating shares previously issued by State enterprises under the 1983 law referred to earlier.

C. Transferring ownership

39. In the final phase of the programme, the share subscriptions are centralized, the Minister for the Economy, Finance and Privatization announces the results, the results are published by the stock exchange authorities and the first market quotations are issued. The investment banks are notified of the number of shares allocated, and the names of the new owners are entered in the stockholders' ledger. Some two weeks later, that is, after about four and one half months have elapsed from the date of the first announcement, transfer of ownership is complete as the State withdraws its oversight from the new

company, the shareholders pay balances owed and the funds are transmitted to the State. All that is left is for the newly privatized company to organize the first general meeting of shareholders.

IV. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING

40. The main thrust of France's privatization programme involved major industrial and financial groups or enterprises operating in competitive national or international environments. As State-owned enterprises, they followed the appropriate charts of accounts required by the Government and they had to abide by the accounting auditing and reporting regulations of the various national and international stock markets, particularly if they had issued securities under the provisions of the 1983 Delors Act. Consequently, there were few implications for the accounting function of a transfer of ownership of a State enterprise.

41. A different situation arises if the activity being privatized was previously carried out under a different form of organization from that of a legal corporation. In the late autumn of 1990, for example, the Government of France began splitting up its postal and telecommunications services, which were operated as a combined activity using governmental rather than commercial accounting. A major international firm engaged for this purpose had to employ some 50 staff members to segregate transactions and re-book telecommunications activities in accordance with the national chart of accounts (plan comptable), leaving the cash-based system for the postal services. The United Kingdom, on the other hand, has required the use of commercial accounting by its separate postal and telecommunications services, so it had no particular system-design problems of an accounting or reporting nature with the telecommunications privatization, nor should it have any with the proposed privatization of the postal services, which is on the present Government's agenda.

42. Insight into the problems of implementing a completely different accounting system can be gained when the legal form of organization is changed, as in the case of the Paris water department. 2/ Faced with large operating deficits, the inability to raise water fees and the urgent need for investment funds to renew and replace facilities, some of which dated back to Roman times, the city decided to farm out its operations privately for a fixed fee. This arrangement took the form of a joint venture, organized as a limited liability company (SARL), in which minority interests were held by two major French water companies. The existing accounting staff had little or no knowledge of commercial accounting so a considerable number of computers were purchased for their use and they were restricted to recording only those transactions that were properly classifiable as outlays under class 6 of the national chart of accounts. All other transactions were recorded by a small group of experienced accountants, who had to be hired for this task, under the direction of a chief accountant with considerable experience in accounting system design and operation. For the first few months, this central group corrected the numerous errors in class 6 accounts when the monthly accounting reports were returned from the firm providing outside computer services. As

the class 6 accountants gained a little working experience, they were required to help with the monthly correction of errors. This practice was of further assistance in cutting down on the rate of errors. By the end of the first year, errors took a few hours rather than several days to correct and the class 6 accountants were ready to expand into other classes of accounts.

43. This case-study demonstrates the usefulness of standardized charts of accounts in situations where accounting staffs have to be trained and need considerable direction and supervision. Because the charts are standardized in France, it takes less time for new accounting personnel to familiarize themselves with a company's bookkeeping system. Also, the availability of detailed instructions, which are a part of the national system, decreases ambiguity and the need to seek a supervisor's advice about how to record transactions. Consequently, the French system can prove valuable in situations where there is low tolerance of ambiguity and a high need for structure - such as exists when new accounting systems are being installed for the first time.

44. The French experienced relatively few problems during the privatizations carried out to date because of the uniform accounts systems referred to above; few companies were being privatized; there was careful planning in the preparatory phase; and the programme was carried out slowly and thoughtfully. The most significant problem was the wide variations in the valuation of the enterprises that result from the use of different assumptions in making the calculations.

Notes

1/ Laws Nos. 86-793 and 86-912, Journal officiel de la République française (3 July 1986), pp. 8240-8241, (7 August 1986), pp. 9695-9697.

2/ Details were supplied by M. Claude Cornuau, the director of the joint venture, who designed and supervised the accounting information system and its implementation.

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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in Germany

Report of the Secretary-General

SUMMARY

Germany is in the unique position of having experienced privatization under two greatly different macroeconomic structures - the market economy of the former Federal Republic of Germany and the planned economy of the former German Democratic Republic, which is now in rapid transition to a market economy. Prior to the unification of Germany, the primary motive of the Government in undertaking to denationalize specific enterprises was to reduce budget subsidies in economic sectors where there were no longer rational justifications for government ownership. To attain this objective large placements of shares were made using national and international capital markets, which were well-developed in the former Federal Republic of Germany. With the currency reform of the former German Democratic Republic on

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1 July 1990, the Federal Government's privatization programme has become an important part of the transition process from a planned to a market economy. The Government has found that privatization could be achieved most rapidly by sales of small businesses to the current managers and employees and of larger enterprises to other established companies. Capital adequacy of newly privatized entities in the former German Democratic Republic is an important issue, which the Government is addressing through the well-established financial infrastructure of Germany and through investment subsidies. Prior to the privatization of an enterprise in the former German Democratic Republic, an opening balance sheet is prepared on a "going concern" basis with amounts revalued from their historical basis to current values, as prescribed by German law. There was considerable delay in completing all the opening balance sheets because of a number of accounting problems, particularly in the area of valuation.

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INTRODUCTION 1/

1. The privatization process in the former German Democratic Republic differs totally from that in the former Federal Republic of Germany. In contrast to other countries, in the former Federal Republic of Germany, there was no wave of nationalization after the Second World War. The business holdings of the Government of the Federal Republic of Germany were therefore comparatively small. The former Federal Republic of Germany none the less had considerable holdings inherited from the former Third Reich and the former Republic of Prussia.

2. With currency reform in the former German Democratic Republic on 1 July 1990, the Government was obliged to shoulder the burden of 40 years of a centrally planned economy and with it responsibility for practically all business property in that country. From 1972 on, more than 90 per cent of economic activity in the former German Democratic Republic took place in state enterprises with detailed production targets and fixed prices and a complicated system of charges, subsidies and external trade. The mentality was that a product was worth whatever it cost to make it. The system's inherent inability to coordinate complex economic activities and to make use of economic incentives resulted in poor economic vigour and weak productivity in the former German Democratic Republic.

I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS

A. Objectives of privatization

1. Former Federal Republic of Germany

3. As early as the 1960s, the Government of the former Federal Republic of Germany had begun to reduce its shareholdings in industrial enterprises. This occurred in internationally acclaimed privatization measures that achieved broad dispersion of the ownership of the shares - Preussag (1959), Volkswagen (1961) and VEBA (1965). At the forefront of the privatizations has been the goal of reducing state business activity as much as possible and restricting public sector activity to the essential functions of Government.

4. On 26 March 1985, the former Federal Republic of Germany adopted an overall concept for a policy on privatization and public ownership. The overall concept contained guidelines for the privatization and management of holdings in a market economy in which the public enterprises are embedded in a pluralistic and mainly private ownership structure.

5. Specific goals of privatization have included:

(a) Developing and strengthening private business initiatives;

(b) Ownership of shares by the public with as broad a dispersion as possible;

(c) Employee stock ownership;

(d) Enlarging the capacity of the stock exchanges and strengthening Germany's position as a financial centre.

2. Former German Democratic Republic

6. After the Second World War, a planned economy was imposed in the former German Democratic Republic. At that time, nationalization of the means of production and the introduction of central control of the economy largely eliminated private property and private entrepreneurial initiative. After the expropriation of key branches of the economy during the period of Soviet occupation, the independence of small and medium-sized businesses was progressively curtailed, culminating in nationalization in 1972. The state enterprises were combined into horizontally and vertically integrated conglomerates; most of them were national monopolies.

7. The reunification of Germany required that the former German Democratic Republic make the transition to an open social market economy as rapidly as possible. In the process, it would be exposed to international competition requiring that private initiative again become the engine of economic development in the new German States. The concept of obtaining customers by manufacturing attractive products at competitive prices in the market-place was a totally new concept to the managers in the former German Democratic Republic. In the past, they were only responsible for attaining their production goals. The Federal Government's strategy to bring them into the market economy was to privatize approximately 10,500 enterprises as fast as possible.

8. Part of the economic unification involved a currency union that went into effect on 1 July 1990, causing an immense shock to both citizens and business enterprises in the former German Democratic Republic. There was no period of transition to a hard currency economic system - it happened in one day. The exchange rates of marks to deutsche marks were not based on relative values generated by the market-place - the exchange rates were based purely on political considerations.

9. The result of this immediate currency union was that manufacturing enterprises in the former German Democratic Republic lost substantially all of their export markets for their goods, mostly because of their dependence on countries belonging to the former Council for Mutual Economic Assistance. Those countries were no longer able to purchase goods from enterprises of the former German Democratic Republic at prices based on former exchange rates - purchases had to be made in deutsche marks at unattractive rates. Under the old system, since customers were more or less guaranteed, managers had no marketing experience. This meant that many enterprises decreased or ceased production, which made the privatization exercise more difficult.

10. The law on privatizing and reorganizing state property (Trusteeship Act), passed by the Parliament of the former German Democratic Republic on 17 June 1990, assigned the task of privatization to the Treuhandanstalt. On 3 October 1990, the Treuhand became a special administrative agency of Germany and its holdings are indirect holdings of the Federal Government. It has been charged with reducing the state's business activity as quickly and as much as possible through privatization, putting as many enterprises as possible on a competitive footing, and making real estate available for commercial purposes.

11. After achieving German unity, the central task of the Government is to quickly revive the stalled East German economy through investment by German and foreign investors. The Treuhand facilitates investment by speedily privatizing, and reorganizing enterprises for privatization, as well as by making available real estate for setting up businesses. Priority is given to privatization over reorganization and, as far as possible, to privatizing reorganized enterprises.

B. Economic, financial and social conditions in the country

1. Availability of local capital

12. Domestic and foreign capital is available for investment in privatization. The banking system is well-developed and has been extended to the new part of Germany. Special programmes have been developed to give support in special cases, such as management and employee buy-outs.

2. Existence of capital markets

13. The stock exchanges in Germany are highly developed. There are about 450 domestic joint stock corporations listed on the exchanges, but no corporation headquartered in the former German Democratic Republic has been listed so far.

14. Under section 65 of the Federal Budget Code (19 August 1989), participation in a business enterprise can only be justified by an important interest on the part of the Federal Government. In 1983-1984, there was a comprehensive review of such interests, which led in several cases to the decision to withdraw completely from the ranks of shareholders in certain enterprises. An example of this situation is the case of Lufthansa Airlines. At the time that Lufthansa was incorporated, private investors were not ready to organize a national airline.

15. This was a change from the privatization policy of the 1960s in one important respect: at that time the Federal Government retained important holdings in privatized companies in the interests of the small shareholders and the company itself. There was no objective justification for this in the 1980s. The large industrial groups in which the Federal Government participated had by the 1980s reached the stage where they could survive

without government backing in competition in the free market either alone as companies listed on the stock exchange or in business associations. The Federal Government sold all its shares in VEBA AG, Volkswagen AG and VIAG AG, in Salzgitter AG and in the Deutsche Industrieanlagengesellschaft mbH.

16. The fears expressed in public discussions by critics of the privatization policy that it would have a detrimental effect on the development of the enterprises and on jobs have failed to materialize. Quite to the contrary, the groups have done very well without government participation. They have been able to plan their group strategies and raise funds on the financial markets free from the administrative and political constraints that government participation inevitably brings with it. Their valuation on the capital markets has improved significantly.

17. The positive development of these groups - the forward-looking consolidation of their position in the markets - is also to the advantage of their employees.

18. Even in the case of partially privatized companies, opening up share ownership to a wider circle has lent new impetus to entrepreneurial activity. The daily consultation on the firm's performance on the stock market and the need to answer to a much expanded general meeting of shareholders have had an invigorating effect.

19. The 20 transactions reducing government holdings since 1983 comprised 11 broadly dispersed national and international placements of shares, three option loans and six share reductions not through the stock market. At the time of subscription, the share placements achieved a wide dispersion. At present, Volkswagen AG, VEBA AG, VIAG AG and Preussag AG are counted among the great German public companies. In this group, Volkswagen AG and VEBA AG have the largest numbers of shareholders.

20. The largest stock sales - more than DM 1 billion volume - VEBA AG, in 1987, and Volkswagen AG and VIAG AG, in 1988, were in the form of international placements, that is, the syndicate included experienced foreign banks as well as German banks. The privatizations increased the capacity of the stock market, strengthened Germany as a financial centre and had a positive influence on the international cooperation of the placing banks.

3. Socio-political considerations

21. In its privatization resolutions of 1985, the federal cabinet stipulated that when Federal Government holdings are being reduced, as far as possible the aim of broad dispersion should be pursued. In particular, efforts by the enterprises concerned to offer shares to their employees should be supported. The Government considers that employee ownership of shares is necessary in a market economy because it helps to avoid social conflicts.

22. When putting the privatization resolutions into effect, the managing boards of directors have offered shares to their employees in all cases where the objective was to achieve broad dispersion of share ownership. This was done in various forms and met with various levels of interest:

(a) In the first privatization, VEBA AG acquired shares from the Federal Government's holding and offered them to the employees, and later did the same with shares resulting from capital increases. Between 1984 and 1985 more than 60 per cent of the employees had already acquired such shares;

(b) In the year of its privatization (1988), Volkswagen AG made one of its shares available to each employee;

(c) In 1987, Deutsche Lufthansa AG decided to increase its approved capital by DM 30 million, which has so far been issued as employee shares in two phases. About half of the domestic staff have used these shares as a capital-forming investment;

(d) Some 80.3 per cent of the 918 employees of Deutsche Verkehrs-Kredit-Bank AG and 62 per cent of the 824 employees of Deutsche Siedlungs and Landesrentenbank have bought shares in their companies;

(e) In 1986, 2,163 employees of Industrieverwaltungsgesellschaft (that is, 50 per cent of the total) purchased shares in their company;

(f) At VIAG AG, 14,000 employees (48 per cent of the staff) subscribed for employee shares in 1985, and in 1988, 12,100 employees (41 per cent of the staff) subscribed.

23. The privatization of equity interests of the Federal Government has made management and staff more aware of the concept of employee shares and has successfully achieved the objectives of the Federal Government. In the former German Democratic Republic, all enterprises were state-owned, but in the future, employees will be given the same opportunities to purchase shares in their companies as the employees in the western part of the country received.

II. PRIVATIZATION METHODS USED IN GERMANY

24. The privatization methods described below are being used in both the former Federal Republic of Germany and the former German Democratic Republic.

A. Contracting-out

25. The technique of contracting-out is used if public services are done less expensively by private enterprises. Economic services are to be provided primarily by the private sector companies that are mutual competitors. For example, contracting-out is being done for vehicle and machinery maintenance, for the development of technical norms or standards and for services such as cleaning government office buildings and refuse collection.

B. Deregulation

26. In Germany, as in most member States of the European Community (EC), statutory regulations against private restrictions of competition are held in high regard. As a result, Germany has a highly developed system of competition law along with an agency to enforce the relevant norms. This policy of the Government led to the decision to privatize all of the state-owned monopolies of the former German Democratic Republic.

C. Trade sales

27. Trade sales are the most common method used by the Treuhandanstalt to promote privatization in the former German Democratic Republic. The advantage is that the purchase price can be negotiated between the Treuhandanstalt and the investor. The investor is asked to present a management plan for the continuation of the enterprise and its restructuring if needed. The new investor's capacity to manage and to invest has proved to be superior to that of existing management where the enterprise was privatized through public offerings. Trade sales are also the most rapid way to privatize. The Treuhandanstalt has been avoiding time-consuming methods of privatization such as public offerings, wherever possible, since delays can lead to losses. The short time factor, however, could give the bidder the chance to purchase the enterprise at a lower bid.

D. Management and employee buy-outs

28. The technique of buy-outs is also used by the Treuhandanstalt to privatize enterprises that require relatively small capital investments, such as garages and workshops. Managers and employees are welcomed as investors, but they have to compete with other investors. If there is a trade sale, the Treuhandanstalt has the power to grant advantages to purchasers, such as delays for payment.

E. Joint ventures

29. Joint ventures were created in the beginning of the transition period, but now this technique is less popular than trade sales or management-employee buy-outs.

F. Share offerings

30. As described above, public share offerings were used in the former Federal Republic of Germany when large amounts of capital had to be raised and when widespread ownership was a major objective. This technique generally creates the most public awareness of the privatization process. It is also the most technically difficult approach, requiring considerable care in

choosing the state-owned enterprise candidate and carefully planning the details of the flotation. Public share offerings have not yet been done for the enterprises located in the former German Democratic Republic.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

A. The privatization programme in the former Federal Republic of Germany

31. To achieve its privatization objectives, the Government reorganized and strengthened certain enterprises and modified its policies on public ownership of others. First, government-owned firms that were operating at a loss were reorganized. To diminish the drain on the state budget, the first priority was to eliminate the source of losses. For example, in 1982-1983, the steel, shipbuilding and processing group Salzgitter reported a group loss of DM 721 million. A new group policy was immediately drawn up and put into practice, with the agreement of the owners, the managing board, the supervisory board and the employees of the enterprise. As early as 1984-1985, the group was making a profit again and after five profitable years, in 1989, it was able to pay dividends for the first time since 1960-1961 and was ready for privatization. The group was sold in late 1989.

32. Another example is the Volkswagen group, in which the former Federal Republic of Germany had a minority interest of 20 per cent after 1961. Volkswagen had a DM 300 million loss in 1982 and in 1983 showed a further negative result of DM 215 million. Since 1984, it has been possible to improve the group's results in every year. Volkswagen is now able to operate in the top ranks of the members of the international automobile industry. The former Federal Republic of Germany sold its holdings in 1988.

33. During the 1970s, the enterprise groups with government ownership operated an expansive holdings policy under the motto "diversification". In numerous cases, that strategy was not successful. In 1983, therefore, the heads of the enterprises were advised to review their holdings and to streamline them. This was subsequently done. Furthermore, the government-owned industrial groups exercised restraint in the acquisition of additional holdings.

34. By March 1990, the groups in which the former Federal Republic of Germany had a majority interest had sold, reduced or renounced holdings at home or abroad in about 75 enterprises. For example, the Saarberg group has separated itself from its four holdings in the German tool industry. In addition, the Federal Government has sold off all its shares in several other groups, resulting in the groups being dropped from the annual report of the Federal Government on its holdings.

35. It was possible to reduce the holdings of the former Federal Republic of Germany significantly (direct holdings, including its first- and second-tier subsidiaries) without special funds, which by 1982 had greatly grown in

number. After a record level of 808 federal government participations in 1982, by the end of 1989, the number of investments had been reduced to 132.

36. By 1990, a considerable amount of budget receipts from privatization sales (DM 9.9 billion) had been realized. This included revenue from the Reconstruction Loan Corporation and the German Federal Railway Special Fund of DM 500 million. Furthermore, the federal budget was freed of enterprises' demands for capital resources to finance their further growth. What cannot be quantified is the relief afforded to enterprises by sales of participations in their group.

37. After their complete privatization, the groups once owned by the former Federal Republic of Germany, had, as early as 1989, already borrowed over DM 3.4 billion in the capital markets. These capital increases were no longer - not even partially - a burden on the federal budget.

B. The privatization programme in the former German Democratic Republic

1. Transition from a planned economy to a free market economy

38. There are three main steps in the transition from the planned state economy to the free market economy:

(a) Conversion of state-owned enterprises and branches operated in forms established under public law, such as the publicly owned enterprises (volkseigene Betriebe) and combines (Kombinate), to legal forms customary under private commercial law and under the law relating to cooperatives, with simultaneous adjustment to international standards - particularly EC standards;

(b) Creation of adequate equity capital for enterprises so that they will be able to compete in a market economy. Here there will have to be a fundamental reform of accounting principles to conform to international standards, particularly the Fourth and Seventh Directives of the Council of the European Communities;

(c) Sale of state enterprises to entrepreneurs and private investors.

2. The legal framework

39. To make the transition to a market economy, the traditional basic legal structure for commercial enterprise needed to be reintroduced. This included the common business forms of sole proprietorships, partnerships and corporations.

40. After 1 July 1990, the Trusteeship Act (Treuhandgesetz) in Germany converted the so-called popularly owned enterprises into private limited companies and the so-called popularly owned conglomerates into public

companies limited by shares (joint stock corporations). This Act also stipulated that after 1 July 1990 enterprises became owners of the assets (including land) that had been legally used by them (by way of so-called Rechtsträgerschaft). These measures have helped enterprises particularly to build up equity and to establish their creditworthiness to creditors, especially to banks.

41. In the case of the former German Democratic Republic, the Assets Act (Vermögensgesetz) has been passed, which together with the Unification Treaty, will restore to rightful owners arbitrary expropriations and nationalization of properties. If this is not possible, people will be given compensation.

3. The work of the Trust Agency in the privatization process

42. The Trust Agency (Treuhandanstalt) was established in the form of an institution under the Trusteeship Act for the privatizing of former state-owned assets. Initially, in addition to the 10,500 companies that were planned for privatization, there were 25 billion square metres of land and 9.6 billion square metres of forests for sale. The Trust Agency is subject to the supervision of the Ministry of Finance. It has the task of selling enterprises to investors - including private investors. The goal is for complete privatization. If partial privatization is unavoidable, complete privatization should be planned and, if possible, assured for a later date.

43. The sale of Treuhand assets are governed by the following procedural principles:

(a) Properties for sale should be widely publicized both at home and abroad to reach as many prospective buyers as possible so that the best of several competing offers may be chosen;

(b) Small and medium-sized firms should get a fair chance to purchase such properties;

(c) Negotiations should be as transparent and objective as possible in order to afford equal treatment to all prospective buyers and to avoid discriminating against smaller and foreign applicants in particular.

44. In reviewing proposals for privatization of enterprises, the Trust Agency considers the following matters:

(a) A practical and achievable business plan for the next three and a half years;

(b) A commitment to guarantee employment for the workers;

(c) A commitment for capital investment in the enterprise;

(d) Assistance with the disposal of land and buildings not required for operations;

(e) A willingness to take responsibility for at least part of environmental risks and liabilities for previous environmental damages;

(f) A purchase price for the enterprise that is realistic and reasonable.

45. From the inception of its operations through 31 December 1991, the Treuhandanstalt has sold nearly 5,000 enterprises or branches of enterprises, including 24,000 retail stores, and has received US$ 8 billion in proceeds. The purchasers of the businesses have guaranteed the jobs of 900,000 workers and have committed to make capital investments of US$ 70 billion in the enterprises. Approximately 200 of the purchasers are foreign (primarily from France, Switzerland, the Netherlands and Sweden), and approximately 900 of the enterprises were privatized by management-employee buy-outs.

46. Foreign investment in former German Democratic Republic enterprises has not been as great as the Trust Agency or the Federal Government would like. Of course, the large number of companies for sale greatly depressed the market for such investments. To stimulate investment, all investors (domestic and foreign) in the new States of Germany are eligible for the following subsidies:

(a) Investment premium (discount on the purchase price) by the Federal Government: 12 per cent of the cost of the acquisition and the cost of manufacturing if the economic goods have been acquired or produced between 30 June 1990 and 1 July 1991. For the period from 1 July 1991 until 30 June 1992, the investment premium is 8 per cent. The investment premium, which is granted upon application, is tax free and does not reduce the depreciable value of assets;

(b) Investment grants by the Federal Government. Grants are made within the framework of regional promotion and can amount to up to 23 per cent. They are granted for the establishment, renovation and fundamental rationalization of a commercial enterprise. A predominantly national sale of the goods produced, as well as the creation and safeguarding of a sufficient number of permanent jobs, is the prerequisite. There is no legal right to these investment grants; they are only granted for particular lines of business deserving aid (especially manufacturing, wholesale and catalogue sales trading). Investment grants reduce the depreciable value of assets for tax purposes;

(c) European Recovery Programme loans of the Reconstruction Loan Corporation and the German Equalization Bank. German businesses, as well as foreign businesses that establish an independent subsidiary in the new Federal States or take part in a business there (joint venture), are entitled to apply for loans. The interest rate at the end of 1991 was 7.2 per cent per year. The term of the loans is 20 years and no payments are due in the first year of the loan.

IV. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING

A. The Deutsche Mark Accounting Act

1. Introduction

47. In a market economy, enterprises survive only if they have adequate capital and if their earnings are sufficient to finance investments and to produce profits. This was not as important in a planned economy because capital could be shifted by Government among enterprises. Accounting mainly served the purpose of monitoring the fulfilment of production targets and not the determination of profits.

48. Consequently, the previous accounting system is not adequate for the proper business management of enterprises. Also, it could not provide useful information to investors and lenders without adjustments to conform to internationally accepted standards. To this end, the Deutsche Mark Accounting Act (D-Markbilanzgesetz or DMBilG) was passed on 23 September 1990, together with the Unification Treaty. The DMBilG, which was amended and promulgated in a new version on 26 April 1991, 2/ obliged enterprises in the former German Democratic Republic to prepare opening financial statements for 1 July 1990, comprising a balance sheet and the related footnotes, a revaluation of assets and liabilities and an adjustment of equity capital. The Act also prescribed auditing and reporting requirements. The revaluation must be carried out in conformity with international standards as set forth in the Fourth and Seventh Directives of the Council of the European Communities. This Act is of considerable importance because it forms the basis for future accounting and reporting. Owing to the fact that in Germany commercial accounts are also used for taxation purposes, the new values will also be used to determine taxable income.

2. Preparation of the opening balance sheet and the reorganization plan

49. The deutsche mark opening balance sheet and the notes thereto are required to give a true and fair view of the enterprise's assets and liabilities. The existing management of enterprises of the former German Democratic Republic lacked the training and experience in western accounting and so were not equipped to produce either an accurate opening balance sheet or a realistic reorganization plan. Consequently, external advice was taken from accounting firms, management consultants and valuation experts. Despite their familiarity with the EC directives and accounting systems geared for the market economy, they encountered a number of problems, discussed in the following section, which considerably slowed down the process. In particular, there was a problem with the quality of the accounting data and the fact that they had to be transformed from one system to another.

50. The opening balance sheet and the reorganization plan were supposed to indicate to the Treuhandanstalt whether the enterprise was capable of surviving. The opening balance sheet, drawn up in a format in compliance with the Fourth Directive, was to represent a starting-point for the bookkeeping after the currency reform. The Fourth Directive requires that the balance sheet be based on the historic cost principle, but if statements were based on historic German Democratic Republic marks, they would not be very meaningful. Therefore, it was decided that monetary items would be converted into deutsche marks at 2:1, land and buildings would be valued at something related to market price and inventories would be valued at net realizable value or replacement cost.

51. Other problems arose since land records did not always correctly reflect what properties were used by the enterprises. It was also necessary to deal with the claims of the former owners.

52. Where an enterprise has a majority holding in another enterprise, it is required to draw up a consolidated opening financial statement comprising an opening balance sheet and notes on the consolidated accounts. This does not apply unless the following size criteria are exceeded: DM 50 million or 500 employees. In principle, the rules regarding group accounting under the Commercial Code are applicable, with due consideration being given to the special aspects applying to a deutsche mark opening balance sheet. The Trust Agency is required to draw up consolidated opening accounts in simplified form.

53. The deutsche mark opening account has to be audited in compliance with the commercial code. Exceptions are made in the case of sole proprietorships and unlimited partnerships and small private limited companies.

54. The other document that is central to the privatization process is the reorganization plan. The document contains a three and a half year business plan for each operating unit which includes a strategy for marketing, personnel and production. These two documents, the opening balance sheet and the reorganization plan, made a logical starting-point for the privatization exercise. However, investors would be more likely to base their decisions on the enterprise's future prospects than on the value of equity as shown in the balance sheet. The opening balance sheet could serve as a useful check-list of assets and liabilities that were to be transferred to the new enterprise. However, the opening balance sheet was not necessarily a useful guide for valuation.

3. Valuation

55. As a general principle of valuation, it was assumed that the enterprises would continue their activities (going concern). The balance sheet shows those assets and liabilities that are to be taken over, together with "the business" as such, and is essential in arriving at a purchase price. A number of specific problems have arisen in the valuation process, such as:

(a) Real estate. The market value was difficult to estimate because there was no market for the land and buildings. The valuation methods used involved comparisons with properties in similar cities and towns in western Germany. Considerable fluctuations are expected for these valuations in the next few years as the former German Democratic Republic is assimilated into the united country;

(b) Buildings. Most valuations were done by western appraisal experts. The status of maintenance and the need for repairs had to be considered, as well as asbestos risks and whether the buildings could continue to be used as intended or there was idle capacity or unsuitable locations;

(c) Machinery and equipment. Comparisons with similar types of equipment in use in other countries was difficult. Factors such as the status of maintenance and the need for repairs, technical obsolescence and continued usefulness in production had to be considered;

(d) Inventories. Overstocking of finished goods and raw materials, and particularly spare parts for machinery and equipment, were common. Possible obsolescence caused by changes in markets for products produced had to be considered when valuing the inventories;

(e) Liabilities. Accruals for social costs of employee reductions, losses on uncompleted contracts and environmental clean-up costs were difficult to value.

56. Provisions, commitments and accruals were recognized, especially for environmental damage. If provisions were needed in the past but were not made, a special loss account was set up on the asset side of the balance sheet at the value of the provision, which, in turn, resulted in a balancing item within the equity capital section.

57. Many value judgements were required in this exercise - more than were normally required in valuing businesses in the west. Some cases of excess conservation and of overoptimism naturally occurred, particularly in view of the shortage of time to complete the work. Consequently, the valuations in the deutsche mark opening balance sheet can be changed if during the preparation of subsequent annual accounts it appears that recognition or valuation/measurements were incorrect and that the sums involved are material. But the items can also be changed for the purpose of the subsequent exercise of an option, given for the deutsche mark opening balance sheet, which will have a corresponding opposite effect on the later balance sheet. Correction is effected in the following year's financial statements; the deutsche mark opening balance sheet is then deemed to have been altered. Changes can be made in the annual accounts until the financial year ending in 1994.

58. Recently, there has been criticism that some former German Democratic Republic business enterprises have been sold at very low prices, based upon the valuation of individual assets and liabilities. The Government has now directed the Trust Agency to revise its valuation guidelines and value enterprises at their fair market values as a going concern.

B. Capital adequacy

59. In the majority of enterprises of the former German Democratic Republic, revaluation of assets was not enough to solve the problem of capital adequacy. To avoid liquidation or bankruptcy and to ensure minimum capital, the Deutsche Mark Accounting Act provides that former state enterprises will have an equalization claim against their parent enterprise if, as former state enterprises, they were transferred to the Trust Agency or to other enterprises for the purpose of privatization and if they were in their exclusive possession on 1 July 1990. The equalization claim amount is the sum that would otherwise have to be shown as the "loss not covered by equity capital" within the meaning of section 268 of the Commercial Law (HGB). The parent enterprise may, as debtor, reject the equalization claim within three months of submission of the adopted deutsche mark opening balance sheet. If the parent company rejects the claim, the claim must be written off. The enterprise will have to go into bankruptcy if the over-indebtedness is not balanced by other means. To equalize its liabilities, the parent enterprise will enter a participating depreciation account, to the extent of the equalization claim, on the asset side of the opening balance sheet, which, being a loss account, is recognized for tax purposes.

60. Conversely, those enterprises with excess capital will transfer the surplus capital to the Trust Agency in the form of an equalization liability.

61. Under section 25 of the DMBilG, if equity capital, after deduction of special-purpose reserves, is higher than tangible fixed assets less real estate transferred on 1 July 1990, the amount must be paid to the parent enterprise (in most cases, this is the Trust Agency).

62. A capital revaluation has to be made by all enterprises having a subscribed capital because of the currency conversion. The subscribed capital has to be created at least to the extent of the minimum capital required by the legal form of the enterprise. The surplus equity capital less special-purpose reserves has to be allocated to a special-purpose reserve in the interest of protecting creditors, and this special-purpose reserve may only be used for offsetting losses. If on capital revaluation it appears that the equity capital less special-purpose reserves is insufficient for creating the minimum subscribed capital, former state enterprises have to record a receivable on the asset side of their balance sheet. The receivable is collectible from the enterprise's parent (in most cases, this is the Trust Agency).

63. Provisional capital revaluations are also permissible in the form of a "capital depreciation" account on the asset side of the opening balance sheet. This capital depreciation account may be fixed at the sum representing the difference between available equity capital and the nominal amount of the subscribed capital shown in the closing balance sheet. But the amount shown in the capital depreciation account is not allowed to exceed nine tenths of the subscribed capital: this is 10 times the amount of the available equity capital. The capital depreciation account has to be written off within five years. To help, enterprises are allowed to capitalize revenues if they can be expected to be realized in the future.

64. Under certain conditions, all enterprises may capitalize the production costs of intangible assets not acquired by a purchase (which normally is not allowed). This will be offset by an amount called a "provisional earnings reserve" with the equity section of the balance sheet. This is only allowed if - after a reasonable commercial assessment - it is believed that the enterprise will be in a position to cover the amortization of the intangible asset against its current revenues without impairment of the equity capital shown in the opening balance sheet.

65. Privatization in Germany has been rather unique in that, in the former Federal Republic of Germany, it has occurred on a slow, deliberate, phased basis, while in the former German Democratic Republic, it is occurring on a massive and rapid basis, with the Treuhand directly selling off approximately 20 enterprises each day. All of the retail and wholesale trading firms, banks, insurance companies and public utilities in the former German Democratic Republic have now been privatized (approximately 24,000 enterprises).

Notes

1/ The present case-study is based in part on written contributions from the Ministry of Justice of Germany and on observations from practising accountants.

2/ Federal Law Gazette, I, p. 971.

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PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in Hungary

Report of the Secretary-General

SUMMARY

The goals of privatization in Hungary are to improve the performance and capacity of the economy and to establish a social and economic system based on private property. The Government attempted various measures beginning in 1968 to stimulate the economy, but they were largely unsuccessful. Most privatizations to date have occurred through joint ventures, spontaneous privatizations, public offerings and competitive bidding methods. Maintaining the Government's ambitious time schedule has been difficult because of the lack of capital, uncertainties about property ownership, inadequate accounting and financial information and inflexibility of governmental regulations. Despite the shortage of capital, the Government has opposed coupon investment schemes which are being used in other Central and Eastern European countries because it fears that enterprise ownership might become too diluted. New legislation and particularly the new accounting law should improve the situation. Historical data is used for pre-privatization financial statements unless foreign capital is being raised. In those cases, an independent fair market valuation is required by the State Property Agency. An audit by an independent accountant is also prescribed by law.

* E/C.10/AC.3/1992/1.

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I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS 1/

A. Objectives of privatization

1. Hungary's first steps towards a market economy started in 1968 with the institution of the New Economic Mechanism. On the first day of January the Government completely abolished the short-term command system and allowed state-owned enterprises autonomy in short-term input and output planning (Kornai, 1986, p. 1693). These reforms, which combined elements of both planned and free market economies, expanded management's decision-making prerogatives and gave much more leeway to state-owned enterprises to finance investments from their own assets or borrowings.

2. Ostensibly, the main objective of state-owned enterprises under the New Economic Mechanism was to maximize long-term profitability. However, there were powerful disincentives connected with the inconsistency and unpredictability of the Government's taxation and subsidy policies. In effect, revenues flowing in from state-owned enterprises in good financial condition were being reshuffled to keep other state-owned enterprises afloat. This meant that special taxation and subsidy rules were applied to meet particular circumstances. The focus of bargaining between state-owned enterprises and the Government shifted from plans, as under the former direct command system, to regulations.

3. Decentralization was pushed further with a new series of reforms in the late 1970s and early 1980s (Richet, 1989, pp. 6-7). To encourage enterprise competitiveness and provide more flexible administration, some 300 new enterprise units were created. The former single-bank system was also broken up, and new, specialized deposit and commercial institutions established. In addition, off-shore and joint stock banks were created which could operate domestically and overseas in both domestic (Hungarian) and foreign currencies.

4. The introduction of interfirm contracting later in the 1980s was a major innovation aimed at expanding industrialization by encouraging the development of small and medium-sized state-owned enterprises and acquiring new technology and know-how through cooperation with western interests. Hungarian state-owned enterprises were permitted to establish subsidiaries or joint ventures with domestic or western companies or enterprises in other socialist countries. These foreign partners could own majority interests and repatriate their profits.

5. Growth of the formal private sector was further encouraged by new legislation allowing the creation of small, service-type firms, whose customers paid according to results, and also by work collectives. A collective, which could belong to either a state-owned enterprise or an independent firm, consisted of between 2 and 30 members who contracted with the parent enterprise to provide services otherwise unobtainable because of labour shortages. Contracting out in this way became a popular vehicle for avoiding certain problems associated with regulated wage rates and working conditions, and work collectives soon numbered in the thousands.

6. While the authorities were experimenting, in piecemeal fashion, with different ways of opening up the stagnating economy, Hungary was slipping into a deepening recession. Its gross hard currency obligations which stood at just over $9 billion in 1980 more than doubled during the next decade, reaching $20.6 billion by the end of 1989 and representing Europe's highest per capita debt.

7. With the state sector accounting for 80 per cent of productive assets and 90 per cent of the national wealth, lack of entrepreneurial spirit at the enterprise level was reflected in the lack of concern over the efficient administration of resources. By the spring of 1988, general dissatisfaction with the economic situation was a major factor in bringing about a series of political changes which eventually led, in the fall of 1989, to a programme of peaceful transition to democracy. Not only were there calls for the transformation of the economic and state ownership structures, but also the financial system needed further modernization, a free market had to be developed, and the nation's foreign economic relations had to be reoriented towards new trading partners and investors, preferably in the West. Foreign capital and technology were needed for the country's industries.

8. The first major attempt to modernize the banking system occurred in 1987 when the previous single bank approach was replaced with a two-tiered structure. The National Bank of Hungary remained the central bank of issue but its business activities were divided among 13 commercial banks for which the National Bank has oversight responsibilities and in which it has majority shareholdings. Further decentralization took place in 1989 when the National Bank gave up its monopoly on foreign exchange, enabling commercial banks to make hard currency loans. This was followed by the establishment of joint venture banks and financial institutions with international capital participation.

9. Tax reforms aimed at improving the state budget and the public finances were introduced in January 1988 when Hungary became the first member of the former Council for Mutual Economic Assistance (CMEA) to introduce a value-added tax (VAT), and a step-wise personal income tax, with basic rates of 25 per cent and 20 per cent, respectively. In addition, a uniform rate of company income tax was introduced to take the place of individual rate negotiations between companies and the tax authorities.

10. Currency convertibility would, of course, help Hungary substantially in its efforts to expand trade with the West. In recent years, balancing foreign trade became particularly critical when, in common with other former CMEA partners, Hungary lost its Soviet markets and was running very large transfer rouble surpluses. Foreign trade was facilitated during the last half of the 1980s when increasing numbers of companies were granted foreign trading rights, and those rights have been extended to any type of enterprise which meets certain conditions. In related efforts aimed at encouraging foreign investment, changes were introduced in the joint venture regulations at the beginning of 1986, and further liberalized later, to simplify the licensing and registration requirements, provide for certain tax advantages, such as

holidays and rate reductions, and to allow for majority or complete foreign ownership.

11. The legal framework for joint ventures and other forms of commercial enterprise is provided by Act VI of 1988 on Economic Associations (the Companies Act), 2/ which went into effect as of 1 January 1989. Six legal forms are available to new businesses: public limited company (Rt.) and limited company (Kft.), general partnership (Kkt.) and limited partnership (Bt.), trade association, and joint venture (Kv.). The two types of limited companies and partnerships follow German structures closely; the trade association has unlimited liability and must be non-profit; and the joint venture, which also has unlimited liability, is profit-oriented, and its own statute spells out various capital-contribution and profit-sharing arrangements.

12. Hungary launched its first privatization programme in September 1990. The economic aims were, by transferring half the economy to the private sector within five years, to optimize the contribution to state revenue, increase the efficiency and competitiveness of Hungarian industry, assist the development of Hungarian capital markets, and promote employee share ownership (Yates and Knight, 1990). Excluded from this process is reprivatization or the return of nationalized property and assets to the original owners. The financial harm suffered by former owners of property has been provided for in the Compensation Act (1991).

B. Economic, financial, and social conditions

1. Availability of local capital

13. Several factors constrain possibilities for the development of the private sector. Hungarian citizens, even though they may be employed in more than one capacity, have low salaries by western standards and, therefore, a low savings base for investment purposes. It has been estimated that if one compares the book value of the net assets of all state-owned enterprises - about 2,000 billion Hungarian forints, or about US$ 30 billion - with the current annual flow of private savings that might be available for purchasing assets other than real estate - which does not exceed Ft 20 billion, or about $300 million - it would take about 100 years for Hungarians to purchase state enterprises at the current savings rate (Action Programme for Hungary in Transformation to Freedom and Prosperity, 1990, p. 21).

14. Therefore, apart from encouraging foreign direct investment, the Government needs to find some mechanism for permitting Hungarian citizens to participate in purchases of national assets. One approach, which is to be adopted in Czechoslovakia, Poland and Romania, is to develop a system for the distribution of privatization coupons, either free or for amounts within the financial capacity of average citizens, which would allow them to participate, directly or indirectly, in share issues. Hungary has decided against this for two main reasons: it wants to concentrate, rather than disperse, ownership so

that there would be greater pressure on management to perform efficiently from a shareholder group; 3/ and it needs budget relief, since its domestic debt in 1990 was about Ft 1,200 billion (about $15 billion), or roughly half the book value of state-owned enterprises. Another approach, suggested by the Blue Ribbon Commission (Action Programme for Hungary in Transformation to Freedom and Prosperity, 1990, p. 21) is to support the privatization programme with a plan to make loans available to Hungarian citizens for equity purchases and to give employees special privileges in acquiring shares through techniques such as free shares for improved productivity or preferential loan arrangements. Some of these philosophies are reflected in the Government's policies. Employees in privatized companies will be able to purchase about 10 per cent of available shares at reduced prices and can obtain subsidized credit of up to 80 per cent of the purchase price if they wish to acquire additional shares. Additional motivation to buy shares is provided in the new tax provisions which took effect at the beginning of 1991 which permit taxpayers to offset their investments in shares and joint ventures against their taxable income (Grosfeld and Hare, 1991, p. 138).

15. Typically, foreigners own about one third of the industrial holdings in many small western European countries (Action Programme for Hungary in Transformation to Freedom and Prosperity, 1990, pp. 40-41). So, the level of foreign investment in Hungary, where only some 3-4 per cent of the productive assets are foreign-owned is, comparatively, extremely low. Looking at the industrial picture alone can, however, convey an erroneous impression of foreign investment interest. By June 1991, there were some 1,200 companies with investments in Hungary, and 7,000 registered joint ventures. Considering the fact that 2,000 of the joint ventures were registered in the first quarter of 1991, it is evident that foreign investment is accelerating. Partial trade statistics show that just under 27 per cent of the joint ventures are engaged in tourism and retailing, 22 per cent are in manufacturing, and just over 11 per cent in construction.

16. With local resistance to foreign ownership reversed, foreign capital invested in Hungary now amounts to $1.8 billion, and the Government hopes for a further 70-80 per cent of this amount to be added in the next 18 months. The United States is the leading investor ($650 million), followed by Germany ($350 million) and Austria ($300 million). To make investment easier and more attractive, some amendments to the Foreign Investment Law were passed in 1991. They included eliminating the special licence requirement for establishing a joint venture, removing restrictions on convertible currency, and allowing dividends from one venture to be used as investment funds in another. By aggressively courting direct foreign investment and successfully steering foreign funds in the direction of productive resources, possibilities arise for the Government to reduce some of the foreign debt by earmarking foreign currency privatization proceeds.

2. Existence of capital markets 4/

17. Hungary has had long experience in capital market operations. The Budapest Commodities and Stock Exchange opened in 1867 and was closed by the socialist authorities in 1948. After 35 years, the securities market opened its doors again in 1983, but the number of transactions did not become significant until 1987 when bond volume doubled to Ft 17 billion. This was the same year that the two-tier banking system was established, and the bond market's success sparked interest on the part of the newly created commercial banks and some other institutions to organize and operate a formal capital market.

18. In the meantime, a Securities Trading Agreement was formed. By 1990 it had 24 banks and financial institutions and three brokerage firms as members. They were to be the nucleus of the future stock exchange which they were pledged to establish, while in the meantime they were to coordinate securities trading in Hungary, collect information on the securities market, and disclose that information to the public. By January 1990, a Stock Exchange Council, an Ethics Committee, and a Securities Trading Committee had been formed and were operating.

19. Time was now ripe for the introduction of legislation governing the issuance of, and trading in, capital instruments, the establishment and operations of a stock exchange, and arrangements for state supervision of the institution and of trading. These are encompassed in the Act on Securities and the Stock Exchange, which came into force in 1990. The Act defines the stock exchange as a legal entity which may be founded by business entities authorized to engage in securities trading so as to facilitate their securities transactions.

20. Part II of the Act defines the legal status, tasks, and scope of the State Securities Surveillance. Its head is appointed by the Council of Ministers, and it operates under the supervision of the Minister of Finance, who specifies its organizational structure and *modus operandi*. A certain measure of independence is provided for in that its resolutions can neither be annulled nor revised in any supervisory capacity, nor is there any recourse against them except as they may be, with certain exceptions, revised by a court of justice.

21. Much of the hard work in building up the securities market has yet to be done. To create a much greater volume of trade, there has to be a greater volume of securities; confidence in the market has to be built up and some measures created to encourage demand; securities brokers have to be trained; the financial community has to learn how to work with financial information; and the statutory auditors have to learn their functions. One event that would add impetus to Hungary's drive to develop its capital markets would be convertibility of the forint.

C. Enterprise circumstances

22. The severe financial difficulties which large Hungarian state-owned enterprises faced in the late 1980s led to the phenomenon of spontaneous privatization when no government bailouts were available and there was no time for financial restructuring to keep an entity together. Privatizing spontaneously essentially consists of a state-owned enterprise unilaterally deciding to sell off some of its assets for some business purpose, such as paying its debts or making necessary purchases or investments. This approach was pioneered in 1987 by Medicor, Hungary's largest producer of medical instruments, when it restructured 10 of its plants into joint stock companies and sold their shares to various investors. Although, theoretically, the proceeds belonged to the nation, they stayed in the company, providing management with a way out of some of its problems. Other large companies readily followed suit, and by 1990, some 150 companies had adopted spontaneous privatization, taking advantage of its relative simplicity and the opportunity it provided managements to hold on to their positions.

23. A negative aspect was the built-in opportunity that existed for conflicts of interest. The restructuring process is largely out of the public view, as are the processes for determining share values and identifying buyers. The four major problems that spontaneous privatization poses have been classified as financial, economic, political, and organizational, as described below (Lee and Nellis, 1990, p. 11):

> Financially, the former managers become owners without paying a "fair price" - though the determination of a "fair price" for enterprise assets is one of the most difficult technical issues in the transition from a socialist to a market economy. Economically, it is hard to see why turning the firm over to the people who ran it poorly in the past makes allocative sense - though as owners rather than agents they might be operating under a dramatically different incentive system. Politically, the new owners will be either former "nomenklatura", whose shift from party elite to asset owners most people in socialist countries would regard as intolerably unjust; or groups of workers (or some combination thereof). Turning enterprises over to workers might be acceptable were it not for the equity problem; i.e. worker ownership might be fine for those employed in profitable or potentially profitable firms, but not for those in persistent loss-making operations or those currently unemployed (and what about professionals, civil servants, farmers, etc.?). Organizationally, denying ownership to the former managerial group eliminates those with the experience and know-how to run the firms.

24. Spontaneous privatization was provided for in the Companies Act and the 1989 Transformation Law. The latter attempts to transfer state assets to the owners at realistic fair market prices.

25. As more spontaneous privatization took place and the wisdom of allowing these processes to continue unchecked was hotly debated, the Government moved to establish control by creating the State Property Agency, as of

1 March 1990. The Agency has two main functions: to approve every transaction in excess of a defined minimum value which involves the transfer or use of state-owned property through sale, rent, lease etc.; and actively to promote, assist, and regulate the privatization of certain groups of state-owned enterprises within the framework it had established.

26. Privatization efforts thus became centralized through the State Property Agency, which, through a July 1990 amendment to its founding legislation, came directly under government control. Organizationally, it is supervised by a board of directors headed by a minister without portfolio, and its staff numbers about 100. Among the senior staff are four independent experts nominated by the opposition parties and the Chamber of Commerce, and officials from five government ministries. In September 1990 the scope of its activities was broadened to require Agency approval of the form of economic association which a transforming state-owned enterprise intended to adopt. Further, the reorganization contract was to be signed by the Agency and not the company (Grosfeld and Hare, 1991, p. 138). This measure reduced any ambiguities about the State's acquiescence in the handling of socially owned assets. The advantages of oversight, orderliness, and consistency in privatization processes were tempered, however, by the disadvantages of a slowing down in progress. During the period from March 1990 through 31 March 1991, about 160 privatization cases came before the Agency: 40 were approved, with a total value of Ft 70 billion (about $1.1 billion).

II. HUNGARY'S PRIVATIZATION METHODS

27. Until the creation of the State Property Agency, spinning off segregable parts of a state-owned enterprise, transforming them into companies, and selling their shares privately had constituted the main privatization technique. Investors from other countries were primarily interested in acquiring assets and not shares of companies, in order to avoid problems of liabilities and having to retain excessive numbers of employees.

28. In September 1990 when the Agency announced its first privatization programme, three types of privatization were identified: those initiated by the State; those by the enterprise; and those initiated externally. In addition to spontaneous privatization, which, under Agency control, was still an acceptable and important option, and leasing, three main methods were proposed for individual privatization which could be used singly or in combinations: public offer of shares and listing on a stock exchange; competitive bidding, either open or limited to pre-selected bidders; and employee-share ownership plans.

29. One of the main reasons for using a public offer would be to attract small investors. The state-owned enterprise would be transformed into an incorporated company under the Transformation Act and go through the usual preparatory procedures for a stock exchange listing. That is, the accounts would have to be audited, a prospectus prepared with the financial data verified by the auditor(s) and, possibly, an asset valuation carried out.

30. Competitive bidding is mainly intended for the sale of shops and transportation equipment, and either an entire concern or parts of it could be offered for sale. Under an open tender, the letter of invitation to bid would describe the participation conditions and requirements and any restrictions on asset use. Pre-selection of bidders would be considered appropriate when the new owner's identity and intentions could have an important bearing on what are perceived to be the nation's long-term interests.

31. Employee-share ownership plans contemplate a range of from 5 to 15 per cent ownership by employees for the majority of the selected privatization candidates. Higher employee participation would be considered under special circumstances; for example, if employees benefit directly from enterprise performance, the size of the workforce is relatively small, and prospects for attracting external investment are poor.

32. The first privatization programme, announced in September 1990, was relatively ambitious. It called for some 505 enterprises to be privatized by state initiative during the three years 1991-1993. The Ministry of Industry and Trade conducted a survey of all wholly or partially state-owned companies, which compiled the following information on each company:

(a) Efficiency and profitability;

(b) Annual net sales;

(c) Amount of debt outstanding;

(d) Operating characteristics (e.g., products manufactured and sold, production and productive capacity, labour and management size and qualifications).

The official government objective was to reduce ownership to below the 40-50 per cent range, and after analysis, the Government decided that the 505 enterprises should be classified as follows:

(a) Companies in which the Government would retain at least a 51 per cent interest for national policy purposes;

(b) Companies in which a 51 per cent interest would be owned by a combination of state ownership and ownership by Hungarian citizens;

(c) Companies for which there would be no restrictions as to ownership of shares by the State, Hungarian citizens, or foreign shareholders.

Table 1 shows the number of companies, relative size characteristics, and revenues which the State expected to realize from the privatization of the 505 companies.

Table 1. Summary of industrial and trading enterprises selected by the Hungarian Ministry of Industry and Trade for privatization, October 1990

	Number of companies	Net sales revenues (Millions of forint)	Total staff	Estimated net profit in latest year (Millions of forint)	Total assets at end of latest year (Millions of forint)	Expected revenues to the State from privatization (Millions of forint)
51% of the shares to remain state-owned	64	828 647	157 326	50 700	477 820	142 686
51% of the shares to be owned by the State or by Hungarian citizens	21	164 456	39 697	6 760	95 974	29 149
No restrictions on domestic or foreign ownership	420	943 386	642 072	22 931	646 852	401 771
Total	505	1 936 489	839 095	80 391	1 220 646	573 606

Source: International Training Centre for Bankers, Ltd., Budapest.

33. The companies were then classified as to what needed to be done in order to accomplish the privatization programme. The best of the group were operating efficiently at the time and therefore required little or no restructuring. Others required relatively small investment by the State or by private investors in order to be run successfully. Another group required major investments in capital, management and professional skills, and the infusion of modern technology. For this latter group, the Government anticipated that the private sector, either domestic or foreign, would have to provide the resources to attain successful privatization. In the last group were companies in which the State did not intend to make any further investments, and if the companies could not be sold in their existing condition, the enterprises would be liquidated. Table 2 is a summary of the number of companies in each of these groups, with further classification by size of the enterprises.

Table 2. Classification of planned privatization of industrial and trading enterprises

	Number of companies				
	Small	Medium	Large	Trust	Total
Efficient companies which could be privatized without any preparation	21	108	94	10	233
Companies that could be privatized after minor investments in capital and other resources	3	27	21	4	55
Companies that required major investments in capital and other resources, primarily from non-governmental sources	52	88	28	2	170
Companies to be sold without investments or to be liquidated	6	29	8	4	47
Total	82	252	151	20	505

Source: International Training Centre for Bankers, Ltd., Budapest.

34. The strongest companies were to be sold by share offerings. Self-initiated privatizations are expected to be received from 300-400 state-owned enterprises during this same time period. The programme anticipated receiving a significant number of external proposals to purchase state property, particularly state-owned enterprises classified as small or medium sized, or to buy shares in state-owned companies.

35. The new programme for such foreign or domestic offers was announced in January 1991 and committed the State Property Agency to respond one way or the other within 30 days. As an incentive to the State Property Agency to speed up the process and to would-be investors to make proposals, the Agency is required to hand down a formal decision within 30 days on any western proposal to transform a state-owned enterprise into a company. The contract may be assumed to have been accepted if no response is made within this time limitation.

36. Within three to five years, the Government wants to privatize completely the construction industry and all companies engaged in wholesale and retail trading activities. Because of a significant reduction in sales to the former USSR, the success of many other companies depends on a restructuring of their products and markets. The Government also wishes to eliminate monopolies in many processing industries such as paper and concrete manufacturing.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

37. The planned sale of the first 20 companies 5/ under the State Property Agency's programme was announced in September 1990, and it was expected that the process would be completed in 1991. The enterprises were from all sectors of the economy and had better-than-average operating performance. Their annual revenues amounted to approximately Ft 100 billion, and the value of their total assets was estimated to be approximately Ft 70 billion. The programme was expected to produce between Ft 30 billion and Ft 40 billion in revenues to the State.

38. For various reasons, plans ran very far behind schedule, and by July 1991 only one of the companies, Panonplast, was ready for privatization. Other major candidates which followed were engaged in a very wide variety of activities, and this variability was also present in the range of book values, revenues, and profits, as well as the proposed privatization methods.

39. In terms of asset values, Richter Gedeon Chemicals (Ft 17,481 million) and Hungarhotels (Ft 10,935 million) led the field, together accounting for over 42 per cent of the total. The two top revenue earners were Centrum Department Stores (Ft 18,610 million) and, again, Richter Gedeon Chemicals (Ft 15,576 million), together accounting for over 36 per cent of the total. The most profitable was Ibusz Travel, whose profit of Ft 1,139 million represented 16.8 per cent of the total profits of the group, as well as 53 per cent of its own assets of Ft 2,144 million and 12.08 per cent of its own revenues of Ft 9,428 million. The proposed privatization methods for

these four companies are described below (Grosfeld and Hare, 1991, pp. 154-155) so as to convey some sense of the diverse activities that occurred:

(a) Richter Gedeon Chemicals: share offering

Share capital is to be raised by 50 per cent during privatization. Foreign ownership may not exceed 33 per cent and Hungarian majority ownership must be maintained. Small investors are to be allotted 15-25 per cent, and employees 5-10 per cent, of the issue, which is to be sold through the Budapest Stock Exchange;

(b) Hungarhotels: technique under consideration

This hotel chain was purchased by a Dutch/Swedish consortium in 1989/90, but the contract was annulled because of what were perceived as highly unfavourable terms for the Hungarian interests. A decision had not yet been reached as to whether to proceed in stages or to sell off hotels individually. A Hungarian majority interest is to be maintained, with possibilities for participation by small Hungarian investors;

(c) Centrum: restructure and share offer

Organizational restructuring will unite certain key operating units into one joint stock company (Rt.), wholly owned by Centrum as a holding company. Foreign participation in shares of the joint stock company will be permitted, but limited to 30 per cent. Some employee participation in the holding company shares is contemplated. At least 40 per cent of the Centrum shares are to be issued through the Budapest Stock Exchange;

(d) Ibusz: public share offering

A 40 per cent interest was sold on the Budapest and Vienna Exchanges in June 1990 and was heavily (23 times) over-subscribed. After a number of gyrations, share prices fell back to their initial levels, so investment success has not been uniform. As long as the State holds 33 per cent of the shares issued, it will retain majority voting control. Exact details of the new share offering are being worked out, and a "golden share" arrangement may be contemplated.

40. In selecting the first 20 candidates, a number of criteria were used by the State Property Agency, including satisfactory enterprise performance, support from management and employees, potential investor demand, possibilities for using various privatization techniques, and any previous privatization preparations (Zoltan, 1990, p. 10).

41. Shortly after the first privatization programme had been made public, 6/ the State Property Agency issued an invitation to bid for the necessary consulting services, and some 200 expressions of interest, including 50 foreign, were received, requesting the general and enterprise-specific terms

of reference. Successful bidders would be expected to carry out the privatization involved, so their proposals had to include such details as future business strategy, modernization and capital requirements, methods to be used, and timing schedule. Personal data about each bidder were also required, including a description of the firm, its staff, and its experience plus the amount of the fee and a detailed budget. Weights of 3-1 were to be assigned to the quality of the proposal versus the proposed fee in the bid selection process.

42. For many of the tender offers, between 20 and 30 western and Hungarian firms submitted bids, putting considerable strain on the Agency's resources. But by the end of the year it had selected most of the banking and consulting firms that it needed.

43. In early December, the State Property Agency announced its second privatization programme, issuing a partial list of 24 companies which would be expanded to a total of 50 later. All of these companies had more than 50 per cent of their assets invested in joint ventures or in other subsidiaries. Existing investors would be permitted to expand their interests or allow others to participate.

44. While the first and second privatization programmes were getting under way, attention was also being directed towards the privatization of small shops and catering establishments. In 1989, there were just over 25,000 of such state-owned units, with 27 per cent of them employing over half of all the active employees in these two sectors and accounting for 57 per cent of the revenues. Efforts to decide on the final legislation ran aground, however, over the topic of foreign ownership, until it was finally decided that investment would be restricted to Hungarian citizens.

45. Act LXXIV of 1990, known as the "pre-privatization law", provides the legal framework for the privatization of the catering and retail trades and of some other small-scale service concerns. One of its main objectives is to strengthen the nation's middle class so transactions that are restricted to Hungarian citizens and only small establishments - that is, retail stores with a maximum of 10 employees and catering establishments with a maximum of 15 employees - are covered. A complicating factor lies in the problem of providing clear ownership title, since premises can only be sold outright to those who were the original owners. Otherwise, premises may only be leased with an option to purchase if and when circumstances permit. Lessees are, however, guaranteed a 10-year tenancy, and there are no restrictions on the resale of operating licences.

46. Once the law took effect, all state-owned enterprises owning units covered by the legislation had to provide the State Property Agency, within 30 days, with information about ownership, asset values, and form of operation, as well as whether they had any prior privatization transactions, what their privatization intentions were, if any, and what would or could be the implications of future privatization. Without the Agency's approval, the state-owned enterprises no longer had the legal right to sell, contract out,

or in any other way transfer such units. It was then up to the Agency to determine the value of the units, set a minimum price, and request bids. In the event of equal proposals, the law defined a sequence of preferential treatment, as follows: the unit's manager; an employee of the unit; an economic association (that is, a company) of the unit's employees; employees of the unit's parent company or their economic association; and, finally, bidders offering a cash transaction.

47. The State Property Agency's time-frame for completing the process is two years, and it targeted some 1,565 retail stores - 1,000 of them located in Budapest - for privatization in the first six months of 1991. By the end of the first quarter, only 1 per cent of the premises available in the capitol had changed hands. This is understandable, given the restrictions on ownership, the lack of domestic capital, and the very high costs per square metre, particularly in the centre of the city. The situation was no better by mid-year, with only 100 shops and restaurants disposed of and blame being placed on the fact that reserve prices were set too high.

48. In addition to the limited ability to raise capital from Hungarian citizens, other factors which contributed to the relatively slow pace of privatization in 1991 were:

(a) Uncertainty about property ownership. There was a certain degree of insecurity caused by lack of settlement of certain ownership issues. This should be solved by the Compensation Act which was passed in 1991;

(b) Inadequate information systems. Records on land registry lacked sufficient information to establish clear titles to real property. The Government is modernizing its property information systems, which should alleviate many problems;

(c) Inadequate accounting information available to measure costs for environmental clean-up and related future liabilities correctly. Also, the method of recording depreciation on fixed assets was inflexible. The new Act on Accounting (1991) should solve most of these difficulties;

(d) Inflexibility of legal regulations on matters such as competitive bidding, management of state-owned property and environmental protection. Recent Government privatization strategies and amendments of laws are being directed to these issues;

(e) High inflation and high rates of taxation. The Government's economic policies are attempting to mitigate these problems.

49. As the privatization process continues, serious concerns have been expressed about the appropriateness of centralizing activities in an agency that is so short of resources. One proposal, put forward by the Ministry of Finance, would be to restrict the Agency's activities to particular groups or types of privatization, while others would be carried out by professionals under governmental supervision.

50. One decentralizing technique which the Agency has announced it will introduce is "asset handling", which is a form of contracting out for services. Bids will be solicited for contracts to protect and augment some of the assets or equities of certain state-owned enterprises. The contracts would be for three-year periods, and the contractor would be required, in return for a property handling fee tied to results, to achieve a minimum growth of 25 per cent of initial asset values.

IV. ACCOUNTING IMPLICATIONS

51. Under Hungary's previous political system, the accounting function was regulated through decrees of the Ministry of Finance, with primary emphasis on bookkeeping. To ensure uniformity in record-keeping and reporting, which was essential for calculating, among other things, national income, the bookkeeping function was organized around a compulsory general chart of accounts, using double-entry techniques, basic documentation and product costing systems, and standardized methods of valuation and financial statement preparation. In common with other systems of governmental accounting, equities were thought of and designated as funds, and assets as uses of those funds.

52. With passage of the Companies Act and the Transformation Law in the late 1980s, certain adaptations were introduced so as to accommodate the new forms of organization. These were reflected in the balance sheet with assets listed in sequence of decreasing liquidity, as in Anglo-American practice, with a new category of intangible assets added, and the various funds which made up the equity of the state-owned enterprises combined under the new title of "homogeneous property fund". This fund subsumed two different accounts: the property fund (or registered value) and changes in the property fund, which would include transactions not yet registered, such as current income. These two titles were changed once more, in 1989, when the property fund became the founder's property and the changes account was retitled "accumulated property".

A. Transition to commercial accounts

53. Despite these adaptations towards commercial practice, accounting still served macroeconomic needs rather than those of investors and creditors. This was reflected in both the design of the accounting and reporting systems and the types and quality of the information they produced.

54. Perhaps the most basic difference in the accounting system design in a non-market economy is the lack of distinction between financial and management accounting. In fact, enterprise financial management, in the western meaning of the term, does not exist. In other words, there is no formal accounting statement which analyses the sources and uses of cash, no use of present-value techniques to record the monetary effects of transactions timed to occur after one year, no accounting techniques to record or assess the effects of inflation, and no financial indicators developed to track and assess

enterprise performance, particularly in comparison with peer institutions. All of these accounting techniques are considered essential to help an enterprise maintain financial health and liquidity in a competitive environment.

55. Instead of analyses of enterprise growth through periodic performance evaluations based on objective standards linked to competitive factors, emphasis has been on the short term and has been equated with success in meeting budgeted targets in an environment which Kornai (1986) has described as one of "soft budget constraint".

B. Information required for privatization

56. In accordance with the Transformation Law, the following information must be provided for the State Property Agency:

(a) Planned date of the transformation and the name and address of the new company;

(b) Economic purpose of the transformation to a private enterprise, the planned share capital of the new company, a preliminary estimate of production and sales, and important expected results from the transformation (e.g., export sales, market expansion, investment, employment etc.);

(c) Information about the investors (other than the management and employees) in the company and what were the preliminary negotiations with them, including terms of their proposed investment;

(d) Latest available balance sheet of the enterprise;

(e) Description of the enterprise business activities, including main products and markets and their significance to the economy of Hungary, main suppliers, and past annual revenues from:

(i) Domestic sales;

(ii) Sales to other countries in the eastern European trading bloc (the so-called "rouble-based" market);

(iii) Sales to western countries.

57. For enterprises previously privatized, desiring to sell all or a portion of their shares to outside investors, the management of the enterprises must furnish to the Agency:

(a) Details of the offer, including the portion of company shares subject to the offer, the currency of the offer, the time of payment, and other conditions and guarantees;

(b) A copy of the draft and the final contract of sale;

(c) A copy of the auditor's letter of appointment and audit report.

If the contract of sale is with a single bidder and is for the majority of the shares in a company with Ft 500 million total assets or Ft 1 billion in net income, the Agency also requires the following information:

(a) Planned new investments and the financing source;

(b) Planned number of employees;

(c) Forecasted annual revenues, new products and new markets;

(d) Forecasted net income in hard (convertible) currencies;

(e) Estimated total market share of the combined acquiring company and the company being acquired, if it is expected to increase by 30 per cent from the previous year's sales.

C. Valuation of enterprises and the transformation balance sheet

58. The valuation information that must be submitted to the State Property Agency in connection with a proposed privatization will vary according to the size of the transaction. Small enterprises that want to sell their assets primarily to Hungarian citizens may use their existing financial statements to value the proposed transactions. Independent valuations are not required. For trade sales of large enterprises (with annual revenues and assets greater than Ft 500 million and Ft 300 million, respectively, or which employ more than 500 persons), a competitive bidding process is prescribed.

59. For each privatization of a large enterprise, the management of the enterprise must engage the services of a valuer to determine the fair market value of the state-owned property. The valuer reports to the enterprise and to the State Property Agency. The specific requirements for the valuation are specified in the decree of the Ministry of Finance 30/1989, VII.1. In making the appraisal of the enterprise, the valuer evaluates the assets and liabilities on the balance sheet and then makes an appraisal of the total business on a going concern basis.

60. Even when accounts are recast into a commercial format, various adjustments have to be considered when examining the basic financial data as a preliminary step in the valuation process. Some of the issues which have to be resolved are:

(a) Collectibility of receivables;

(b) Effects of excluding fixed manufacturing costs and of including variable selling expenses in production inventories;

(c) Possible decline in the market values of purchased and manufactured inventories below recorded amounts, including provisions for excess quantities and obsolescence;

(d) Proper ownership and valuation of land and buildings;

(e) Accounting for leases; in Hungary, all leases are considered to be operating leases and the capital lease accounting method is not followed;

(f) Valuation of intangible assets purchased or otherwise acquired, including appropriate accumulated amortization; in the past, intangible assets were not amortized;

(g) Provision for known or probable future liabilities; taxes on profits and dividends payable are currently not required to be recorded; also, provisions for potential losses from contracts, warranty claims, environmental obligations, etc. must be considered.

61. In addition to the valuation, the State Property Agency generally requires financial statements in accordance with international accounting standards for the past three years, along with a business plan and financial forecast for the next five years, a summary of significant contracts, and a description of significant contracts and investments.

62. If the Agency approves of the proposed privatization, the management of the enterprise must prepare an offering (tendering) booklet for submission to potential bidders. Based on this information, potential purchasers submit their bids directly to the enterprise for evaluation. The most important criterion is price, but attention is paid to the plans of the prospective investor for future operations of the enterprise.

63. Large corporations may also be privatized by share flotations. In such cases, the business valuation forms the basis for negotiating the price of the shares to be sold.

64. In accordance with Law No. XIII/1989, after the privatization has occurred the enterprise must prepare a "transformation balance sheet" which must be audited by a chartered accountant who is registered with the Ministry of Finance. This balance sheet must be based on the valuation that was made of the business. Assets are to be valued at replacement cost, existing use value, or disposal value, based upon the judgement of management and the auditor. Replacement costs are defined in the law as the gross replacement costs adjusted by accumulated depreciation for the age of the assets and for obsolescence and scrap value upon disposal. Intangible assets such as patent rights and brand names are also valued.

65. In addition, a "closing" balance sheet must be prepared as of the transformation date. The difference between the total net assets amount shown on the closing balance sheet and the total net assets amount on the transformation balance is to be charged or credited to the retained earnings of the enterprise.

66. Goodwill may be recorded as an asset if the purchase price of the enterprise exceeds the valuation of the assets and liabilities prepared for purposes of the transformation balance sheet.

67. The auditor's task of making sure that the financial statements of a privatizing state-owned enterprise are complete, prepared in accordance with generally accepted accounting principles, and provide a true and fair view of financial condition and results of operations are necessary not only for valuation purposes but also for use in the prospectus for companies whose shares are to be listed on the stock exchange. As the Act on Securities and the Stock Exchange (1990, p. 110) pointed out:

> A most crucial point of the Hungarian securities market about to be developed is the shortage of information. Investors are, in many cases, forced to make their decisions in the absence of the necessary information. This is due to the fact that for a long time issuers had no significant liabilities regarding the disclosure of information. Companies limited by shares may be formed also by an open founding, the public offering of securities has not been regulated ... and the so-called "public offering" procedure well-known in the countries with advanced capital markets has been missing.

D. The new Act on Accounting

68. Under the new Act on Accounting (1991), which takes effect as of 1 January 1992, reporting entities, referred to as entrepreneurs or economic agents, are to prepare an annual report consisting of the balance sheet, the income statement, the notes, and the business report. Valuation methods follow international accounting practices, with the following exceptions:

(a) Provisions for bad debts are not required;

(b) Inventories resulting from production are recorded at prime direct costs (direct materials and direct labour) and are not valued at the lower of cost or market;

(c) Investments of less than 50 per cent in other companies, other than temporary investments, are valued at cost. The equity method is not used as yet. Temporary investments are valued at the lower of cost or market in accordance with international standards;

(d) No adjustments are required for the effects of inflation.

A new accounting law is expected to be passed in 1992 which is supposed to deal with these matters.

69. The formats of the new financial statements are consistent with the EC's Fourth Directive. The notes are to contain numerical and explanatory data necessary for providing a reliable, true and fair view of the net assets, financial position, and the results of operations, in addition to that presented in the two main financial statements, for the owners, investors, and creditors. The comprehensive listing of items to be contained in the notes is consistent with the disclosure requirements in developed market economies. The business report is to present an evaluation of the annual report and should cover any significant events since the date on the balance sheet; data concerning the acquisition of treasury shares; and any research and development activities.

70. The most difficult matters for accountants and auditors to deal with are the recording of the costs of land and buildings, and the recording of valuation allowances for possible bad debts and for declines in the market value of inventories below acquisition and production costs.

71. The annual report, together with the auditor's certificate and the proposal or resolution as to the disposition of the after-tax profit, is to be deposited with the Court of Registration within five months of the end of the fiscal year - that is, by 31 May - where anyone may obtain information about it and make copies. This privilege also extends to the business report, which need not be filed as a part of the annual report but must be made available for inspection and copying at the reporting entity's seat of business. The annual report, including the auditor's statement but excluding the business report, must be published by companies limited by shares, limited liability companies with capital in excess of Ft 50 million, single-person limited liability companies, and economic entities issuing bonds. The notes, or parts of them, need not be published if, according to the auditor's statement, the data shown in the balance sheet and income statement are sufficient for an unambiguous evaluation of the actual net assets and the results of operations. This is not in accordance with the views expressed in Conclusions on Accounting and Reporting by Transnational Corporations, issued by the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (United Nations, 1988), because the notes are considered to be an integral, and not separable, part of the financial statements.

72. The new accounting law continues to accord standard-setting jurisdiction to the Minister of Finance. However, there is to be a new advisory group, the National Accounting Board, whose President and members will be appointed by the Minister, whose main tasks are to make recommendations about amending existing accounting standards, or creating new ones, and monitoring the implementation of the new system as well as accounting regulations and practices abroad. It is expected that the Board will have about equal representation from the Ministry of Finance, the professional body of Hungarian auditors, and leading academic accountants so as to have some diversity of experience and viewpoints. While this solution still leaves accounting and fiscal regulation under one administration, the advisory body will be helpful in broadening perspectives about the different sets of

objectives that guide the development of accounting standards and fiscal regulations in Hungary.

73. At the present time, the practicing accountants in Hungary are going through training programmes developed by the Ministry of Finance to teach the practical application of the new accounting law to their enterprises, including how transactions are to be recorded in the accounts and how financial statements are to be prepared.

E. The audit function

74. As in other non-market economies, the Hungarian expert accountant was an arm of the State in a control capacity and consequently may not be compared with the independent professional, as understood in the West. Auditing was not considered a separate discipline, and auditing manuals were primarily directed at verification, rather than analytical, techniques. In market economies, the auditing process takes place in several stages. One of the important preliminaries is the assessment of the internal control system and an analytical review, aimed at attempting to quantify the amount of audit risk. The risk assessment will be a major factor in determining the amount of detailed examination that should be performed. In addition, some of the examinations may be carried out on a sample basis, the size of the sample likely being determined statistically. Notions of statistical sampling, analytical review, and risk assessment are virtually unknown in non-market economies. Consequently, some considerable retraining is necessary in not only the basic auditing function but also the subsidiary activities that typically accompany an audit engagement, such as certain types of financial consulting. These very different types of auditor qualifications mean, of course, review of the curricula for accounting and auditing education as well as training requirements and auditor certification.

75. The State Property Agency has rules for avoiding conflict-of-interest situations. If the auditor is engaged to make the business valuation or to audit the transformation balance sheet, he or she is not allowed to purchase any assets of the enterprise or any of its shares of stock.

Notes

1/ This case-study is based in part on written contributions from the Ministry of Finance of Hungary and from Dr. Istvan J. Friedrich, International Training Center for Bankers, Ltd., Budapest.

2/ The term "economic association" denotes a commercial or industrial undertaking and does not include cooperative firms, state enterprises, or state farms.

3/ To managers accustomed to negotiating with a small group from the central Government, greater pressure could emanate from a larger group of investors.

Notes (continued)

4/ This section is drawn mainly from the Act on Securities and the Stock Exchange.

5/ For a complete listing, see Hungary Country Report, No. 4 (1990), p. 10, and Grosfeld and Hare, 1991, pp. 154-155.

6/ Zoltan (1990) is relied on for details of the Agency's operations, except as otherwise noted.

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